

**MUNICIPAL CREDIT
MARKET DEVELOPMENT
IN BULGARIA:**

**POLICY AND LEGAL
FRAMEWORK**

Prepared for



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TABLE OF CONTENTS

EXECUTIVE SUMMARY	i
I. INTRODUCTION.....	1
A. Relation To Overall Local Government Reform Agenda	1
B. The Timeliness Of Municipal Credit Market Reform	2
II. KEY POLICY CONSIDERATIONS	5
III. THE EXISTING CONTEXT FOR POLICY REFORM	16
A. The Nascent Market for Municipal Credit.....	16
1. Trends in Borrowing; Characteristics of Municipal Loans	16
2. The Demand Side: Municipal Credit Demand and Investment Needs	21
3. The Supply Side: The Willingness and Ability of Financial Sector Institutions to Hold Municipal Debt	22
B. Municipal Creditworthiness	27
1. Economic Health	27
2. Adequacy of Local Budgeting and Financial Management.....	32
3. Central Government Financial Controls	35
4. Revenue Stability and Predictability	36
5. Sources of Investment Finance.....	40
C. Municipally-Owned Companies (MOCs)	43
1. Overview.....	43
2. Water and Sewerage	46
3. District Heating	47
4. Garbage Collection	49
5. Urban Public Transport.....	51
6. Summary	51
IV. FINDINGS AND RECOMMENDATIONS	53
A. Recommended Legal Reform Strategy	53
B. Elements of a Comprehensive Law on Municipal Credit.....	57
1. Municipal Authority to Borrow	58
2. Purpose of Borrowing	60
3. Restrictions on the Issuance of Municipal Debt.....	63
4. Characteristics of Debt	70
5. Disclosure.....	79
6. Prudential Investments of Proceeds	82
7. Purchase and Resale of Bonds.....	83
8. Lender Remedies in Case of Default	83
9. Central Government Approval, Monitoring and Intervention	85
10. Conclusions	88
C. Recommendations on Municipally-Owned Companies.....	89
D. Measures to Strengthen Municipal Creditworthiness.....	92
1. Improving and Stabilizing Municipal Financial Condition	92
2. Reporting on Municipal Financial Condition	100
3. Dealing with Municipal Insolvency	102

TABLE OF CONTENTS (Continued)

E. Related Issues and Recommendations	106
1. Investment Grant Design and Administration	106
2. Other Financial Sector Laws and Regulations	108
V. CONCLUDING NOTE: RELATED INSTITUTIONAL DEVELOPMENT NEEDS.....	113

ANNEXES

ANNEX A: List of Laws and Regulations Reviewed by Project Team

ANNEX B: List of Persons Interviewed

ANNEX C: Water and Sewerage Enterprises in Bulgaria by Type of Ownership

ANNEX D: Municipal Budget Data

ANNEX E: Background Reports Consulted

LIST OF TABLES AND CHARTS

Table III.1: Bulgaria—Illustrative Loans to and Bonds Issued by Municipalities	1
Table III.2: Possible Sources of Municipal Credit.....	24
Table III.3: Projected Pension Assets of Pillar II and III (1999-2005)	25
Table III.4: Treasury Bond Yields	26
Table III.5: Interest Rates and Government Security Yields, July 1999.....	26
Table III.6: Share of Local Government Expenditures in GDP/General Government	27
Table III.7: Structure of Local Government Revenues	28
Table III.8: Local Government Budget Balances – Aggregate for all municipalities.....	30
Table III.9: Local Government Budget Balances – By Population Groups	32
Table III.10: Unfunded expenditures for all local governments by population category	33
Table III.11: Revenues of Local Governments.....	37
Chart III.1: Structure of Current Revenues in 1998, by Population Category	39
Table III.12: Financing of Local Investments (on Budget)	41
Table III.13: Permitted Level of on Budget Investments and Borrowing	42
Table III.14: Total Investment Spending – On- and Off-Budget	42
Table III.15: On- and Off-Budget Investments by Population Category - 1998.....	43
Table IV.1: Municipal Debt Limitations in Selected Countries	69

TABLE OF CONTENTS (Continued)

LIST OF BOXES

Box II.1: Stakeholders in Municipal Credit Market Development.....	15
Box III.1: Local Government Budgets – Creditworthiness Analysis Approach.....	29
Box III.2: Municipal Enterprises As Opposed to MOCs.....	45
Box III.3: Concession Arrangements as a Substitute for Public Investment and the Use of Municipal Credit.....	47
Box IV.1: The Philippines: How Fear of Political Risks Can Inhibit Municipal Credit Markets....	59
Box IV.2: Example of language on the binding nature of financial obligations.....	60
Box IV.3: Examples of language on short-term debt.....	65
Box IV.4: Republic of Lithuania, Decree on Usage of Bank Credits by Local Authorities, 1998	66
Box IV.5: Example of language on securing debt with own source revenues.....	78
Box IV.6: Example of language stating that municipal debt is not an Obligation of the Government.....	79
Box IV.7: Restrictions and Monitoring of Public Sector Debt in Relation to GDP	87
Box IV.8: Rules for Local Budgets in Other European Countries (Separation Of Operating And Capital Budgets)	94
Box IV.9: Rules for Local Budgets in Other European Countries (Balanced Budget)	94
Box IV.10: Rules for Local Budgets in Other European Countries (Carry Over of End of Year Surpluses)	95
Box IV.11: Capital Improvement Planning and Budgeting: Some Basic Concepts.....	96
Box IV.12: Example of language to allow taxes to be set within a range of minimum and maximum levels.....	98
Box IV.13: Example of language to index fee levels based on inflation.....	98
Box IV.14: Example of Information Provided in the Debt Annex of French Local Government Budgets	101
Box IV.15: Example of Requirement for a Public Debt Registry - Romania	102
Note: This is the text of Article 52 of Romania's 1998 Local Public Finance Law.....	102
Box IV.16: Example of Procedure for Debt Adjustment and to Address Municipal Insolvency - Hungary	104
Box IV.17: Example of Procedure for Financial Stabilization to Address Municipal Bankruptcy - Latvia	105
Box IV.18: Example of Procedure to Address Municipal Debt Default: Romania	105
Box IV.19: Hungary - Multi-year allocations of targeted investment subsidies	108

EXECUTIVE SUMMARY

This report presents findings and recommendations for improving the legal framework for municipal credit market development in Bulgaria. It is based upon an extensive review of existing legislation and field work (including consultations with all major stakeholders from both the public and private sectors) conducted toward the end of 1999.

As in all post-Communist Central and Eastern European (CEE) countries, Bulgarian local governments are faced with the challenge of remedying years of under-investment and under-maintenance in basic infrastructure and building stock, and of addressing stricter pollution control requirements. *Well-designed investment and borrowing plans often can finance the construction of needed capital investments today, and then repay the debt that is incurred from the future earnings of the facilities themselves over their useful life.*

A Policy Overview

The report discusses the following key considerations, which should govern the development of a national policy in support of municipal credit market development:

- ***The Primacy of Decentralization.*** Assigning a priority to local credit market development presupposes a government commitment to decentralize important parts of local public service delivery—along with the financial resources that are commensurate with these responsibilities and that are sufficient to establish local governments as creditworthy borrowers in the private capital market.
- ***The Potential Role for Municipally Owned Companies (MOCs).*** The reform strategy should help strengthen and enlarge the role of MOCs as in most instances the preferred vehicle for organizing and delivering public utilities and other services that lend themselves to operating on a largely self-financing, business-like basis.
- ***The Desirability of Competition between Banks and the Municipal Bonds Market.*** Competition among financial sector institutions can help keep the cost of capital as low as possible for municipal borrowers. The legal framework should not discriminate between bank loans to municipalities and municipal bonds.
- ***Rethinking Collateral Requirements: Pledges of Future Revenues as Preferable to Physical Collateral.*** Policy should encourage the credit market to look to pledges of reliable and recurring municipal (and MOC) revenues to secure local government debt (as opposed to pledges of municipal property).

- ***The Potential of Government Transfer Intercepts.*** A number of countries authorize voluntary arrangements between a municipality and a creditor that allow the creditor to “intercept” central government transfers should the local government default on a debt obligation. If well designed, such arrangements can strongly enhance municipal credits without any risk or cost to the central government.
- ***Tax Law Neutrality.*** Tax laws exert a powerful influence on credit market allocations of capital, and they should be examined to ensure that they do not discriminate against any class of municipal borrower or type of municipal borrowing.
- ***The Proper Government Role in Municipal Debt Issuance.*** Policy should respect the legitimate central government interests in the integrity of the municipal finance system and the level of overall public debt (sovereign and sub-sovereign). Here the report notes that aggregate municipal debt in Bulgaria remains trivial relative to the municipal share of total public expenditures and thus does not warrant any prior central government restraint at this point in time.
- ***Pros and Cons of a More Activist Government Role.*** If the opportunity arises, should Bulgaria consider creating some form of Municipal Development Fund (MDF) which would on-lend monies for local investment projects using an international donor line of credit? The report notes that this may represent the only prospect for introducing longer term (10 to 15) municipal lending in the near term. But it also strongly cautions that the international experience with MDF institutions has been disappointing on the whole. Any such fund (as well as any other government grant and lending programs for local investments) should be designed with care to ensure that it supports (rather than undermines and competes with) private credit market development.
- ***Municipal Credit Market Supply and Demand.*** To date, municipal lending activity has been minimal. The research identified only a handful of municipal credits in place, most with a maturity of only a year. Reported total municipal debt issuance in 1998 was only 22 million BGN. The weakness of effective municipal demand poses the major constraint on municipal lending today. The study assessed the borrowing capacity of Bulgarian local governments today by calculating typical net operating savings: i.e., the recurring net revenues available to service any debt obligation after paying all operating costs. The results for 1997-98 revealed an average net savings rate of only 3 to 4 percent (compared with 40 percent in the Czech Republic and 15 to 25 percent in Poland). Thus the market remains in a formative stage during which it can be hoped that a few of the larger cities (with relatively healthy



economies) will participate in the credit markets and establish some sound precedents for future growth in municipal lending as, over time, more local governments get their economic houses in order.

- On the supply-side, the unusually high liquidity in financial institutions promises an adequate supply of credit relative to effective municipal demand. This conclusion assumes that reasonable macro-economic stability persists and that lenders become less cautious about accepting some risk in exchange for higher yields than they can earn on state guaranteed securities. For the moment, lender inhibitions extend to all forms of credits. However, when contemplating loans to municipalities, lenders (in addition to their understandable concerns about underlying municipal creditworthiness) are shy of the perceived political risks of depending on future mayors and municipal councils to honor debt obligations. In respect to credit market structure on the supply side, commercial bank assets dwarf those of the pension funds and insurance firms. However, as the new Pillar II (mandatory private) component of the pension system comes on line, the pension funds could emerge as significant participants in the municipal credit market as it begins to take shape.
- ***Necessary Attention to Longer-Term, Institution Building.*** The legal reform strategy elaborated in this document must be embedded in a larger policy framework that further clarifies the roles of the public and private-sector entities that are engaged in the operation of a municipal credit market and the related requirements for their institutional development.

The Recommended Legal Reform Strategy

Based on the our field research and comparative experience from other countries, we recommend a legal reform strategy for municipal credit market development consisting of three major elements:

- This first set of recommendations describe a comprehensive *Law on Municipal Credit*, that aims, at one and the same time, both (i) to encourage and (ii) to better regulate those Bulgarian municipalities (a small number at present) who have the financial capacity to make greater use of private credit to finance critical investments.
- Secondly, the report recommends enacting some parallel regulatory constraints on the use of private credit by MOCs, and also comments on broader reforms needed to strengthen their financial viability (and hence, their ability to borrow);

- The third set of recommendations aims at increasing the number of local governments (one hopes, in time, virtually all municipalities) that are creditworthy borrowers and that can routinely utilize debt financing to meet a significant portion of their capital investment needs.

The study also reviewed financial sector laws and regulations as they may influence municipal credit market development, and concluded that, in their relevant aspects, they allow the municipal sector to compete for private credit on equal terms with other economic sectors. The report does recommend relaxing certain criminal code provisions that may contribute to excessive bank requirements for loan collateral from all borrowers (including municipal loan applicants).

The Need for a Comprehensive Debt Law for General Purpose Local Governments

Existing municipal and financial sector laws in Bulgaria do not comprehensively address the debt of general purpose, local government debt. Relevant rules are largely indirect, scattered among various laws and regulations or established on an informal basis. In several important instances they are incomplete or ambiguous. Thus we strongly recommend a comprehensive and consolidated set of legal provisions to govern municipal borrowing, which could be enacted as a separate *Act on Municipal Credit*. As appropriate, this new law would amend existing legislation that impinges on municipal debt issuance such as the *Law on Public Offerings of Securities*, the *Registered Pledges Act*, and the *Banking Act*, as well as the *Municipal Budgets Act* and the *Local Self-Government and Local Administration Act*.

Whether or not a new and comprehensive Act is approved, legislative action in some form should address the most serious deficiencies and needs, namely:

- Reinforce the binding nature of municipal debt obligations (on future municipal councils).
- Clarify the authorized public purposes for municipal borrowing: specify that any temporary borrowing for cash management purposes must be repaid within the same fiscal year; only permit long-term borrowing for capital investment; constrain municipal borrowing that primarily benefits a private party.
- Establish a debt limit, based on the level of debt service, to preclude municipalities from borrowing beyond their means, and prohibit balloon repayments of principal; eliminate the present limit on investment expenditures.
- Require MoF approval for issuing municipal credit denominated in a foreign currency.



- Allow municipal governments, as legal entities, to perfect and register pledges of own-source, future revenues, and thus provide the legal basis for revenue bonds and bank loans secured by dedicated local revenue sources.
- Eliminate any implication of implied central government guarantee of municipal credit; authorize local governments and lenders, on a voluntary basis, to use state-aid intercepts.
- Clarify remedies in the event of municipal insolvency and establish clear priorities among lenders and other classes of creditors; in event of default on a municipal bond, authorize bondholders to designate a representative to act on their behalf.
- Establish specific disclosure requirements for municipal bonds that give private investors confidence that lending to municipalities is a manageable risk and that they can obtain the information needed for sound underwriting of municipal debt.
- Encourage standardization of documents (for private as well as public placements) to facilitate secondary resale of municipal securities.
- Require prompt notice to the Ministry of Finance upon issuance of any municipal credit and in the event of a serious default by a municipal borrower.

Recommendations on Municipally-Owned Companies

MOCs, as companies whose operations are governed by commercial law, enjoy greater latitude in seeking and structuring investment credits than do the general purpose local governments to whom they are accountable. As a result, the scope of recommendations addressed to MOCs is narrower and briefer than those aimed at debt issuance by general purpose local governments themselves. Nonetheless, some improvements to the enabling frameworks for MOCs are needed both:

- To make sure that the legislative regime (particularly in respect to tax policy) does not discourage channeling municipal investment through self-financing MOCs when appropriate.
- To provide similar protections against ill-advised forms of borrowing as would be recommended in the more comprehensive law that would apply to municipal governments.

MOCs to become active borrowers need to implement the type of full cost pricing (along the lines authorized in recent water and energy sector legislation). Here progress also requires resoluteness on the part of municipal mayors and councils in approving



adequate tariffs and supporting aggressive collection policies. As a general policy, subsidies should be provided for commercial municipal enterprise services only through transparent transfers from budgetary organizations, including the municipality.

Measures to Strengthen Municipal Creditworthiness

Building a better legal and institutional framework for fiscal decentralization is critical to advancing a wide array of objectives aimed at achieving more effective and responsive local government in Bulgaria. From the narrower perspective of municipal credit market development, clearly progress on this front is a pre-requisite for private lending to emerge as a major, if not the predominant, means for financing local investment needs. The recommended reforms would:

- Strengthen municipal authority and capacity to increase revenues and control operating expenditures, with an eye to generating a meaningful level of annual net savings in the operating budgets on a predictable and recurring basis.
- Motivate and reward those municipalities that take the initiative to borrow and invest, particularly for capital improvements that pay for themselves through savings in operating costs.

Specific reforms which would advance the above objectives include: (1) establishing a budget with separate operating and capital accounts, and multi-year capital investment plans, that would include the ability to carry forward surpluses; (2) granting greater local discretion to set fees and taxes; (3) instituting a more transparent and predictable system of transfers; and (4) allowing more local responsibility for the forecast of own source revenues.

The report makes additional recommendations for improving the capacity of local governments to manage their finances in a more effective and accountable manner regardless of their financial condition. Here, when viewed from the prism of credit market reform, the chief aims are:

- To simplify due diligence for lenders. Financial institutions will be more inclined to take the trouble to underwrite municipal credits if they have ready access to reliable information on municipal financial condition—particularly in respect to accrued and contingent liabilities and outstanding indebtedness.
- To give suppliers of credit confidence in the financial procedures, systems, and management capacity of local government that will help ensure timely repayment.



In conclusion, Bulgaria has a unique and timely opportunity to establish a well-conceived policy and legal framework in advance of the municipal credit market's development—rather than having to return later, as many other countries have had to do, to implement remedial measures on a retroactive basis.

MUNICIPAL CREDIT MARKET DEVELOPMENT IN BULGARIA: POLICY AND LEGAL FRAMEWORK

I. INTRODUCTION

Relation to Overall Local Government Reform Agenda

This study was undertaken in support of the Local Government Initiative (LGI), a major ongoing United States Agency for International Development (USAID) program. It also builds on the broader policy recommendations set forth in *Bulgaria: Municipal Finance Reform Strategy*, an Urban Institute (UI) study funded by USAID in 1997.

The LGI aims to help Bulgaria move toward a more effective and responsive system of municipal governance consistent with the principles set forth in the European Charter of Local Self Government to which Bulgaria is a signatory. It advances these ends both through assisting with the preparation of national policy and legislation in support of fiscal decentralization and through a variety of capacity building activities at the local level. As part of this effort, the LGI, acting through the National Association of Municipalities of the Republic of Bulgaria (NAMRB) supports an intergovernmental working group (with participation of national and local officials). A major focus of this working group has been the review of laws and regulations governing intergovernmental transfers and the level of autonomy granted municipalities to manage their own finances (local own-source revenue authority; local control over budget preparation and execution).

The present study seeks to inform and support the LGI's ongoing policy work, in particular:

- By setting forth a comprehensive set of legal provisions to better govern the issuance of municipal debt. The Government could assess these measures and enact them relatively quickly without delaying to resolve and act on more fundamental and complex policy choices in respect to the overall legal and institutional framework governing fiscal relations between local and central governments. These recommendations would at once seek to both encourage and better regulate municipal borrowing:
 - **Encourage**, by providing those few municipal governments that clearly can afford to borrow for investments with the necessary flexibility to better compete for attention in the private credit market and to meet the needs of lenders for securing municipal debt.
 - **Better Regulate**, by introducing more appropriate controls on the amount and form of municipal debt as well as extending greater protection for unsophisticated purchasers of municipal bonds.

- By presenting a set of recommendations for strengthening local government finances viewed from the perspective of private capital market participants who, as lending to municipalities becomes more common, will be evaluating the creditworthiness of municipal borrowers and their local investment projects. Here the report, from this distinct vantage point of the commercial banker and municipal bond underwriter, reinforces a number of analyses and recommendations already under consideration by the LGI and its legislative working group.

The Timeliness of Municipal Credit Market Reform

At some point in the next few years, establishment of a local credit market is likely to become a high-priority policy issue in Bulgaria, as it did during the 1990s in Poland, Hungary, the Czech Republic and several other countries in the region. Attention to enabling the legal framework for municipal credit market development in Bulgaria would prove timely for the following reasons:

- During transition, Bulgaria assigned significant responsibilities to local governments for the capital investments required to sustain essential public services in the social sectors (health, education) as well as public utilities and environmental management services.
- Bulgarian municipalities confront an intimidating backlog of unmet capital needs in terms of deferred replacement and repair of aging local infrastructure and facilities—not to mention a long hiatus in the development of new construction urgently required to serve the needs of a modernizing society. Local governments clearly cannot rely on increased central government transfers to fund these investments. Simply stated, their best hope (if not immediately, but nonetheless in the near to mid term) is to look to private sources of investment capital. Throughout the developed world, healthy and active municipal markets are an inevitable accompaniment of well-maintained communities, which provide the reliable services and infrastructure, demanded by its businesses and citizenry.
- Accession to the European Union (EU) will require a massive investment in environmental repair and improvement, much of it in landfills, incinerators, water treatment plants and other facilities at the local level. As in other countries aspiring to join the EU, the Bulgarian public sector will have to contribute significantly to these investments and to meeting the 25 percent country match required to obtain EU pre-accession grants. Developing the ability to leverage local investment resources through access to private debt financing will be a precondition for municipalities to contribute their share to this massive undertaking.



- Since the end of the 1996-7 economic crisis, a small number of municipalities have turned to private capital markets to finance local investments. As detailed in the full report, this brief history of municipal credit already demonstrates some encouraging progress in the willingness of municipalities and their lenders to risk longer term loan commitments and to explore less familiar forms of loan structures explicitly tailored to the characteristics that distinguish municipalities from private borrowers. Assuming continued macro-economic stability and financial sector strengthening, lending to local governments through commercial banks and municipal bond issues can be expected to accelerate.
- Bulgaria still retains a window of opportunity to establish a well-conceived legal framework for municipal credit markets that can help preclude the emergence of problems, which other transitional countries have had to address retroactively.
- In recent public statements, Prime Minister Kostov has advocated amending the Constitution of Bulgaria to authorize municipalities to unilaterally set local tax and fee rates. At present, the Constitution requires Parliament to legislate all such local tax and fee rates. Adoption of such a Constitutional amendment would strengthen the capacity of local governments to raise revenues and repay debt.
- Recent articles in the Bulgarian press reported on the anxiety among some government leaders and informed observers that municipal initiatives to promote their securities, if not properly regulated, could backfire in a way that might undermine the orderly growth of a municipal credit market.

Annex A identifies the large number of laws and regulations assembled and reviewed as part of this study. The authors consulted with the entire gamut of public and private sector participants who will be involved in the development of relevant policy and laws and in the operation of the municipal credit market as it emerges, including:

- National level officials from the Ministry of Finance, the President's office, the Securities Commission (SSEC), Parliamentary officials, and line ministries and other agencies engaged in overseeing sector specific investments.
- On the "*demand*" (or borrower side), officials in a number of the municipalities that have engaged in commercial borrowing to date (including mayors, finance directors, and the heads of Municipally Owned Companies).
- On the "*supply*" (capital market) side: officials of commercial banks pension funds, insurance companies.

- The Bulgarian Association of Municipalities and the trade associations representing each of the major categories of financial sector institutions.
- Representatives of international donor organizations and their contractors working on related reform topics.

Annex B contains a complete listing of the individuals who were interviewed. The first part of this study presents a policy overview for thinking about municipal credit market development followed by a brief assessment of the existing context for related reforms. A detailed set of recommendations is presented in the third major section of the report. Each recommendation is preceded immediately by a brief review of the relevant aspects of present law and practice to which it is addressed. The presentation includes excerpts of language from existing laws in other CEE and Western European Countries.

II. KEY POLICY CONSIDERATIONS

The term “municipal credit market” is shorthand for a credit market open not only to municipal borrowers, but also to Municipally Owned Companies (MOCs), joint public-private ventures and other entities that implement local capital investments. Work on appropriate laws and regulations to govern municipal credit market development should take place within a larger policy framework based on the following considerations.

The Underlying Objective. The promotion of more borrowing by municipal governments and MOCs is clearly *not* an end in itself. Borrowing by local governments that finances current-account deficits increases the stock of debt obligations that must be paid by future taxpayers without increasing productivity and means of repayment. Premature borrowing, before a municipality has established its creditworthiness or identified clear investment priorities, is likely to drain local budget resources and add risk to the fiscal system.

The underlying purpose of municipal credit market development is to increase the volume of local capital investment in support of essential municipal services. At a time when governments at all levels in Bulgaria face severe budget constraints, prudent borrowing can augment investment capacity. *Well-designed investment and borrowing plans often can finance the construction of needed infrastructure facilities today, then repay the debt that is incurred from the future earnings of the facilities themselves through user charges or through cost savings in service operations.*

Importance of Addressing the Policy and Legal Framework before Municipal Lending Accelerates. For the moment, Bulgaria has the great advantage that no explosion of local government borrowing is underway. Many other countries have found themselves confronted with the reality of large-scale local borrowing, then have been obliged to try to construct *ex post facto* a legal framework that will accommodate the healthy borrowing that has occurred while curbing the excesses. Bulgaria is in a position to develop the legal and policy framework first, and to do so at a reasonable pace, in anticipation of future market development. Bulgaria also can learn from risks that have become clear in other countries. From Brazil to Russia, excessive borrowing by sub-national governments, or debt issuance in the absence of an adequate legal framework (one that clarifies critical issues like the status of guarantees or the remedies available to lenders in the event of a municipality’s non-payment) has exacerbated national economic crises. The promise of soundly based local borrowing is large, but the risks involved in badly prepared borrowing also are large. All parties (local governments, national government, banks, and potential investors in municipal debt) share an interest that the policy issues surrounding credit market development be well understood, and that an appropriate legal framework be in place before the market springs into action.

The Primacy of Fiscal Decentralization and the Policy/Legal Framework for Building Municipal Creditworthiness. Assigning a priority to local credit market development presupposes a government commitment to decentralize important parts of

local public service delivery, along with the financing of such services and the capital facilities essential for their provision. In an efficiently decentralized system, municipalities or MOCs will have some choice about the character of services they provide and the extent of local service coverage. They will have responsibility for raising at least part of the costs of service delivery at the local level, in the form of taxes or user fees. They will face the need to finance from own resources at least part of the capital costs required to upgrade or expand infrastructure networks, perhaps in collaboration with a central government that provides capital grants or other forms of co-financing. Finally, for decentralization to be a reality local authorities will need to have some flexibility as to local tax rates and local fee schedules, so that they can pay for the level of investment and service delivery that they have chosen. In a decentralized system, local taxpayers have a good part of the final say in what levels of public services a municipality will provide, given the costs of service provision.

A local credit market, in other words, fits within a public finance system that assigns significant decision-making power and financing responsibility to local governments. It is not clear at this time how fully Bulgaria has and will embrace municipal decentralization, or how quickly it will move in this direction. *It is clear that a local credit market should be viewed as an instrument that helps municipalities and MOCs play a larger role in local capital investment. Bulgaria would be mistaken to rush ahead with preparations for municipal borrowing, without simultaneously building the rest of the policy and legal framework that enlarges local government's role and revenue resources, within the bounds of fiscal discipline and hard budget constraints.*

The Prospective Role of Municipally Owned Companies in Local Infrastructure Investment. The policy framework should consider expanding the role of Municipally Owned Companies in undertaking critical local investments. As entities registered under commercial law, MOCs can access debt financing without risking municipal government credit—or adding to sub-sovereign debt in the calculation of limits on consolidated public debt. And, if established on a business-like, self-financing basis, they can provide for delivery of services on a more cost-effective basis than when similar services are provided by organizations funded directly through the municipal budget.

In Bulgaria, responsibility for most basic urban services, such as water supply and sewerage, district heating, garbage collection, and public transport, is vested in special-purpose entities, which, during the transition period, have, for the most part, been organized as commercial companies that operate under the commercial laws. To date, decentralization of these utility-type functions to the municipal level has been somewhat limited. The State, with the exception of Sofia, continues to own all of the companies providing local district heating, and it owns or holds a controlling interest in a substantial majority of the water and sewer companies, including virtually all those in the larger cities. Municipalities do own the balance of the water and sewage companies, and, through either MOCs (or through budget-funded, municipal enterprises) collect



garbage, maintain landfills, and operate urban transportation systems. However, since the vast bulk of capital financing in all of these areas is presently provided by the State, meaningful municipal-level decision-making authority in respect to investment remains much less than the ownership structure might suggest.

For a municipal credit market to play a significant role in future investment, more of the responsibility for deciding investment priorities and financing investment will have to be shifted to the local level. There are various options for achieving this:

- The direct investment responsibilities of municipal governments could be widened.
- Municipal ownership of service companies could be strengthened, and MOCs made responsible for financing more of their own investment through the service fees they charge.
- Some MOCs (particularly in the largest cities) could be privatized.
- Municipal governments may choose to finance more basic investment themselves, turning over completed assets to local MOCs for service operation.

A local credit market should support any of these options, making it possible for different kinds of legally recognized institutions that finance basic local investment to gain access to the credit market on comparable terms, if comparable risk is involved.

Before a significant volume of municipal lending can take place, the revenue structure of municipalities and MOCs will have to be clarified and strengthened, so that their ability to repay debt is clearer. Again, a pre-condition for development of a robust municipal credit market is prudent decentralization of public revenues and revenue-raising authority.

Recent legislation that liberalizes tariffs for several categories of urban utilities represents a heartening first step towards genuine creditworthiness and expanded use of private sector financing by MOCs engaged in this sector. However, before prudent lenders can be expected to finance MOC investments without looking to municipal governments for supplementary guarantees, MOCs and the municipal councils that oversee them, must demonstrate over a number of years their political will to enact tariffs based on full-cost recovery principles and the administrative tenacity to collect them.

The Desirability of Competition between Bank Lending and the Municipal Bond Market. Municipal debt instruments themselves can vary. A bank loan to a municipality is structured differently from a municipal bond that pension funds or other

investors buy. However, the two forms of credit can serve the same purpose of intermediate-term investment financing for a municipality. Historically, some parts of the world, like Western Europe, have relied more heavily on bank loans than bonds sold in the capital market for municipal credit financing, while other countries, like the United States, have relied more heavily on bonds. There are some important distinctions between the two instruments: a publicly sold municipal bond requires more publicly disclosed financial and other information than does a loan made by a bank. In a bank loan, information typically is disclosed only to the lenders. A country like Bulgaria, newly embarking on development of a local credit market, however, has no reason to legally choose one form of lending over another. The same basic legal framework can and should apply to both types of debt instruments without discriminating between them. Competition between banks and a bond market can help keep the costs of capital as low as possible for municipal borrowers.

Forms of Debt Security: General Obligation Pledges and Pledges of Future Revenues vs. Pledges of Physical Property. A shift away from the present preoccupation with physical collateral and toward general obligation and revenue-based financing may well prove to be a significant precondition for sustained growth in the volume of private sector lending to local governments. Among the considerations that underlie this conclusion:

- As privatization continues, the amount of municipal “private” property available to pledge as collateral will continue to contract—particularly the inventory of property clearly suitable for transfer to the private sector. MOCs in particular have few “surplus” physical assets that are not integral to maintaining the services they provide.
- Experience in other countries suggests that in practice it is extremely difficult for private creditors to foreclose on pledges of municipal property in the event of serious loan defaults. Most developing and transitional countries tend to rely most heavily on general obligation financing –i.e., debt secured by a pledge of all of the local government’s budget resources.
- Much local capital investment finds its justification in a proposed project’s ability to decrease the costs of underlying public services. Here, reliance on real estate collateral detracts attention from the project’s underlying economics. If loan repayment is predicated on revenues or cost savings to be generated from the project, both the municipal borrower and the lender tend to focus with more discipline on the economic costs and benefits of the proposed undertaking.
- For lenders, one potential attraction of municipal government borrowers (when compared with private sector firms) is their permanence and sizable and relatively predictable future revenue streams. In addition to local taxes



and fees, future revenues include shared taxes and fees for essential public services. Moreover, MOCs have the potential to pledge revenues from reliable streams of future income from the fees and tariffs that they charge.

The Potential of Transfer Intercepts. In Bulgaria, the largest and most reliable source of local revenues will remain for some time to come from the taxes collected by the central government and transferred to local governments—most importantly the shared personal income tax (PIT) and the own-source component of the corporate income tax (CIT). A number of countries use legislatively authorized “intercepts” of such intergovernmental transfers to enhance the ability of local governments to offer extremely reliable security for their borrowing. Such intercepts can provide a strong boost to credit market development without any implied central government guarantee or other cost to the national treasury. As such they merit particular consideration in the development of municipal credit policy and law. The recommendation section addresses these considerations, as well as problems associated with over reliance on this *de facto* form of credit enhancement, in further detail below.

Tax Law Neutrality. In general, credit markets configure themselves to take the fullest advantage of tax policy. Tax laws, particularly exemptions for interest income, have a powerful effect on the development of municipal credit markets and the motivation for different categories of lenders and investors to participate in such markets. As a rule, tax policy should:

- Ensure that municipal governments and MOCs can compete for private capital on even terms with other public entities.
- Strive for neutrality among different forms of municipal borrowing (in respect to the public purposes of borrowing, and the respective classes of creditors and borrowers).

The Proper Central Government Role in Municipal Debt Issuance. Even in a decentralized public finance system, the central government retains a legitimate interest in the integrity of municipal budgeting and financial management. One fundamental interest is that municipalities provide the basic public services expected of them, before they invest in non-core activities. A second fundamental interest is that municipalities prepare and execute balanced operating budgets. In respect to the oversight of municipal credit, the central government has two critical concerns over and above ensuring compliance with legally mandated procedures:

- One interest is limiting the consolidated public sector's outstanding debt-- to comply with international agreements, to preserve the government's ability to borrow abroad, and most importantly, to build a solid base for the national economy and future participation in the European Union. The consolidated public deficit includes the deficits of municipal governments; the outstanding

stock of consolidated public sector debt includes the debt of municipalities. Although the debt of the Bulgarian public sector (which includes both sovereign and sub-sovereign debt) has been declining as a ratio of GDP, in 1999 it remained well above the limit of 60 percent established by the European Union for its members.

- To guard against highly imprudent borrowing that could threaten the integrity of the overall public finance system and put pressure on the national government to deliver costly bailouts.

Nonetheless, in drafting a municipal credit law, the authors caution against authorizing the Ministry of Finance to exercise prior restraint of municipal debt issuance:

- In respect to management of aggregate public sector debt, it should be noted that, even though municipal budgets account for nearly 20 percent of all public sectors spending in Bulgaria, total outstanding municipal borrowing represents a trivial portion (a fraction of one percent) of total public sector debt. For the near term, placing prior restraints on municipal borrowing will have no meaningful impact on lowering the overall public debt sector ratio.
- At the heart of the rationale for private capital market development, is the confidence that the self-interest of banks and other financial institutions will motivate them to assess the ability of borrowers to repay their debts. To duplicate this function in the government requires sophisticated institutional capacity within the Ministry of Finance or another appropriate agency. Even when this institutional capacity exists, there is little reason to believe that the monitoring agency will do a better job of assessing credit risk than the lenders and the rating agencies (or, for that matter, the municipalities themselves). Moreover, central government review and approval of municipal credits can raise the specter of an implicit guarantee, with municipal bondholders or lenders likely to hold the oversight agency responsible in the event of payment default.

Thus, for the time being, the recommended reform strategy argues that the municipal credit legislation abstains from creating a new level of review and approval. The recommendations of this report does address forms of legislated debt limits and monitoring that can provide some protection against local imprudence. The wisdom of this course could be reassessed in a few years in the light of further accumulated experience with municipal lending.

Should the Government Assume a More Activist Role in Stimulating Credit Market Development? Policy for municipal credit market development should be informed by a clearly defined goal in respect to achieving a meaningful level of lending activity over the near term (say five years). Comparative international experience



suggests that a private credit market is unlikely to coalesce without some triggering forms of assistance or intervention that can help capital market participants become familiar and comfortable with the underwriting of municipal credits, and make available longer-term credits (up to 20 years) that domestic lenders are presently unable to provide.

Certainly, technical assistance and training directed both at prospective municipal borrowers, commercial banks, and other financial institutions can make a useful contribution towards this objective. That said, can technical assistance alone prompt a significant expansion in private sector lending to municipalities? Although mature local credit markets now are dominated by private-sector lenders, many developing and re-structuring nations have passed through a transitional stage when public institutions or arms of the national government played a role in most of the long-term lending to municipalities—often by on-lending funds loaned or guaranteed by an international donor.¹

As Bulgaria's government weighs its policy options for actively facilitating municipal credit market development, it should consider the mixed lessons that can be drawn from this comparative international experience. On the one hand, a few countries have had, on balance, a positive experience with on-lending international donor funds through some form of "municipal bank" or "development fund". Brazil's municipal development funds lend directly to local governments; thus far they have an excellent record of repayment and have established some positive precedents for the private financial institutions that may follow their lead. The Czech MUFIS offers a relatively unique and exemplary model. MUFIS was established from its inception to operate as a second-tier, financial intermediary that extends a credit line of medium-term funds to private, commercial banks. The banks in turn lend to municipal governments for infrastructure projects and assume 100 percent of the risk for the loans that they underwrite. Repayment history has been essentially default free and the program has motivated participating banks to expand municipal lending using their own resources.²³

On the other hand, despite the success stories, as often as not, municipal development loan funds have compiled unacceptable default rates and ended-up competing with or actively interfering in private credit markets in ways that distort market

¹ The majority of Western European nations have a similar legacy, with financing through long-term domestic funds. Some have only relatively recently privatized their municipal credit institutions (France, Belgium, Spain).

² A similar World Bank funded initiative in Poland has gotten off to a slow start. Yet another World Bank project modeled in large part on the Czech experience (twin local development funds for the Republic of Srpska and for Bosnia and Herzegovina) has just gotten underway.

³ MUFIS perceives that it has already accomplished its initial objective of private credit market development; currently it is addressing the question of its medium term, residual role and fiduciary responsibility until the longer-term (30 year) donor credit is repaid.

incentives, and perpetuate public subsidies. Moreover, it is difficult to point to instructive models for how such finds should be wound down, once they have accomplished their initial purpose and a private municipal credit market has firmly established itself. Should they be dismantled or converted to perform some more modest, residual role (technical assistance provider, regulator, more narrow, special purpose lender)? Complicating this question, is that these municipal development funds typically have residual fiduciary obligations that may extend out as long as 30 years until the original donor credit is fully repaid, even though the initial infrastructure loans to participating municipal entities may all have been repaid within ten or fifteen years. “Although Municipal Development Funds in some parts of the world now are celebrating their 25th anniversaries, they have largely remained captive instruments for on-lending funds provided by international institutions and central governments.”⁴

Is a more activist, transitional public sector role in municipal lending appropriate? In effect, transitional countries at Bulgaria’s early stage of credit market development confront a dilemma:

- The likelihood that some form of government on-lending fund may prove essential to jump-starting a significant level of infrastructure financing.
- Balanced against this realization, a substantial risk that, without an unusual degree of political and bureaucratic self-restraint, a local development fund could prove counter-productive to the objectives of sound, private credit market development.

If after carefully assessing the opportunities and the risks, the Government of Bulgaria should chose to create some form of Municipal Development Fund (that on-lends from an external credit line), it should do so with the clear intent:

- That the Fund be established for the sole purpose of supporting the development of a private credit market.
- That it operates through commercial banks who would assume the responsibility of underwriting the risk of infrastructure loans extended to participating communities.
- Related to the above points, that it be designed to operate swiftly and predictably, and to refrain from performing time-consuming independent project appraisals which needlessly delay project financing and construction by imposing a redundant layer of review, and which relieve banks and municipal borrowers of their proper decision making role.

4 George E. Peterson, Building Local Credit Systems, Urban Management Program Discussion Paper, Urban Institute, May 1997.



The Complementary Design of Other Government Local Investment Grant and Loan Programs. In the previous section we discussed the pros and cons of Bulgaria pursuing an external credit line (from EBRD, the World Bank) and establishing a Fund to prime private credit market development. Questions of such a fund aside, policy should also recognize that, typically, even developed countries, with mature municipal credit markets, maintain government grant and/or loan programs in support of local capital projects. (These are similar to the Bulgarian MoF's Targeted Investment Grant Programs or the grant and loan programs operated through the Bulgarian Environmental Protection Fund). Regardless of purpose, it is essential that such programs be designed in a way that encourages and complements the efforts of local governments that can afford to finance investments using their own resources (including the use of private municipal credits). Moreover, it should be kept in mind that the conduct of public lending institutions (no matter how narrow their mandate) will inevitably influence the shape and behavior of the private, municipal credit market. It therefore is important that such institutions adhere to lending standards consistent with those that the government wishes private financial institutions to maintain. There are several basic principles that all lending institutions, public or private, should follow, but that may require particular focus on the part of public lenders:

- ***Insistence on timely loan repayment.*** The bedrock of any credit system is its history of repayment. The track record of local government and MOC repayment will establish the creditworthiness of the municipal sector in the eyes of the capital market. Public institutions such as environmental funds need to actively monitor and collect payment on municipal loans, even if such loans are funded from the public budget and made at a concessionary or zero interest rate. Nothing will be more damaging to development of the municipal credit market than establishing the precedent that municipal loans may not have to be repaid.
- ***No national government guarantees and no national government bailouts.*** For a local credit market to stand on its own, and for the national government to be able to insulate its risks from those of municipalities, it is critical that municipal lending, from whatever source, **not** be backed by national government guarantees or be rescued by a national government bailout. An efficient credit market requires that lenders carefully assess risk and make loans based on their own risk assessments. No credit analysis of this kind will occur if there are government guarantees, since the lender will look to the Government for eventual repayment rather than to the creditworthiness of the municipality. Around the world, the recent record is replete with excessive lending to local governments in circumstances where national guarantees exist, or where the legal framework is sufficiently ambiguous that some lenders believe there is an implicit national guarantee. As stated at the outset, rapid development of the local credit market is not an

end in itself. Establishment of a prudent market, capable of assessing risk and supplying capital over the long run, is the objective.

- **Avoidance of interest-rate subsidies.** Development of a private-sector, competitive credit market will be speeded if public lenders do *not* lend at subsidized interest rates. As long as subsidized loans remain available, few municipalities will choose to borrow from other lenders at market rates. If the national government wants to subsidize investment in certain sectors or in certain types of activities, it should do so (as it does, in some cases, at present) through targeted grants that pay a limited portion of the investment cost. Municipalities then have an incentive to fund the remaining costs on their own, including the use of private, market-rate financing.

It must be acknowledged that most countries, in Central and Eastern Europe as well as the rest of the world, do not in fact adhere to this pure standard of avoiding subsidized interest rates in all municipal lending. Environmental funds around the world, for example, lend to local governments at subsidized rates. Although not recommended, such subsidized loan programs need not undermine private, credit market development, provided that the government clearly defines and demarcates the forms of local projects eligible for subsidized lending from the rest of municipal investment. The subsidized loan then becomes a kind of “targeted” loan (analogous to a targeted grant), leaving municipalities free to raise their local matching funds in the form they find most cost effective.⁵

The Overriding Imperative of Institutional Development and Capacity Building. No matter how well conceived, a Municipal Credit Law cannot hope to contribute significantly to the emergence of a properly regulated, efficient municipal credit market unless it is embedded in an overall strategy for institutional development and capacity building. Although not the focus of this study, such a process must engage all of the key participants in the municipal credit market from the demand and supply sides as well as other key stakeholders. (See box II.1) The detailed study recommendations address areas in which the recommended law must clarify the roles and responsibilities of key participants in a manner that minimizes distortion of market efficiency or weakening of local financial discipline.

⁵ See Chapter IV.E.1 for further recommendations on investment grant design and administration.



BOX II.1: STAKEHOLDERS IN MUNICIPAL CREDIT MARKET DEVELOPMENT

Demand Side (Borrowers)	General purpose local governments, Municipally Owned Companies (MOCs), public-private joint ventures
Supply Side (Creditors)	Commercial banks, specialized banks, insurance companies, pension funds, wealthy individuals
Market Makers	Stock Exchange; Licensed Financial Intermediaries; Financial Advisory Firms; Credit Rating Agencies (in future)
IFIs	World Bank; European Bank for Reconstruction and Development
Overseers & Regulators	Ministry of Finance, Supreme Chamber of Control, State Audit Office, Securities Commission, Bulgarian National Bank, IMF
Technical Assistance Providers	USAID, US Treasury and SEC advisers, World Bank, EBRD

III. THE EXISTING CONTEXT FOR POLICY REFORM

A. *The Nascent Market for Municipal Credit*

1. Trends in Borrowing; Characteristics of Municipal Loans

At this point in time, Bulgaria cannot be said to have a functioning market for municipal credits in the sense of either:

- A primary market where local governments can routinely go to finance their investment needs, and with a sufficient volume of activity for the transactions between the suppliers and users of credit to have established any discernible pricing patterns.
- A secondary market where primary lenders can liquidate municipal credits and replenish their capital for making new loans and where private investors (both institutional and individual) can buy and sell municipal credit instruments.

That said, as documented in Table III.1, below, one can point to some nascent municipal lending activity by primary lenders as Bulgaria has recovered from the 1996-7 period of hyper-inflation and collapse in the banking system. No doubt, the beginnings of a secondary market in the purchase and resale of municipal credits remain several years away—not surprisingly, given the absence to date of a secondary market for even far more established and lower risk forms of government securities.

In the course of our research, we identified only eleven municipal loans from 1994 to the present that have been made to Bulgarian municipalities by Bulgarian banks and only three municipal bonds that have been issued to date or are in process of being underwritten. Table III.1 summarizes the characteristics of these loans and bonds. Here we should note that this Table should be read as illustrative only. We are reasonably confident that it captures the major municipal lending thus far, but undoubtedly there have been other bank loans which we did not identify.⁶ As can be seen:

- Only two of the loans were made prior to the banking collapse (both to Sofia in 1994). The other nine loans were all closed in 1998. Each had quite an abbreviated maturity. All had terms of only one year with the exception of a three year loan to Rousse (which the City chose to prepay after the first year).
- Three of the loans funded road repairs (as opposed to a genuine, long term investment project); another three appear to have been for temporary cash-

⁶ For example, one of the bank officials interviewed indicated that the bank had made a few loans to municipalities but, for proprietary reasons, declined to identify them.



flow management purposes,⁷ only one was made to fund an investment designed to pay for itself through operating cost savings (the purchase of energy conserving street lights in Sevlievo).

- Six of the loans were collateralized with municipal property (either pledges of real property and/or shares in municipal companies). In two of these instances, the real estate pledge consisted of a youth center, a type of public facility that should not be used as collateral and there by put at risk of foreclosure.
- Again, with the exception of the Rousse credits, the interest rates for the one year, 1998 loans varied between 9.5 percent and 11.5 percent, essentially a premium two to four percent over one-year treasury bills marketed over the same period. The rates seem roughly comparable to those extended to private firms with good credit.

Despite this small volume of lending activity, some modest encouragement can be taken from this abbreviated history:

- Gabrovo and Troyan pioneered loans that looked for their security to pledges of future municipal revenues in lieu of physical collateral. The three municipal bonds issued or pending all look to an all-inclusive pledge of the local government's assets (including revenues)—in effect, these are general obligation bonds backed up by the full good faith and credit of the municipality. These represent positive precedents for the development of a municipal credit market. (However, none of the credits involved the pledge of dedicated, discrete revenue source--with the partial exception of the Gabrovo loan which did provide for a supplementary pledge of monies in the city's privatization fund.)
- For credits issued over the recovery period from the '96/'97 financial crisis, to the best of our knowledge, the municipal borrowers have met their debt service repayments to their private creditors without any major default. (Credit market participants remain aware and somewhat chastened by the failure of Plovdiv to repay a credit issued much earlier in the transition period.)

⁷ As detailed in the findings and recommendations sections of this report, short-term borrowing for cash-management purposes that is not repaid within the same fiscal year is not consistent with sound, municipal financial management and should be prohibited.

The Sofia Eurobond represents the only municipal bond that has been successfully underwritten to date. Some critics have questioned whether or not the Eurobond was financially advantageous to the City. Regardless of how one answers this question, the Eurobond represents a positive precedent in two respects:

- For the first time, a sub-national entity from Bulgaria was recognized as creditworthy in the international capital market.
- Despite the unfavorable timing of the bond issue (underwritten as the Kosovo crisis was unfolding), the City received a credit rating for the bond comparable to the international credit rating accorded Bulgarian sovereign debt.

Table III.1: Bulgaria—Illustrative Loans to and Bonds Issued by Municipalities
Loans to Municipalities

Name of Municipality	Purpose	Year Loan contracted	Amount of Loan	Bank(s)	Maturity	Interest rate	Collateral/ Security pledge	Other conditions/ Comments
Sofia	Road rehabilitation and repair; Metro	1998	22.3 million new BGL	Syndicated loan Lead Bank: BulBank, with 14.5 million new BGL	1 year with 1 year grace period	9.5 percent	125 percent of loan value; one-half consisted of shares in municipal companies, and another half with municipal real estate	Pledged property was assessed at 30 million new BGL; pledged real estate included a hospital and a kindergarten.
Sofia	Purchase of tangible fixed assets	1994	109 thousand new BGL	UBB	1 year	13 percent	Promissory notes	Funds automatically withdrawn from the bank account. The loan already repaid.
		1994	31 thousand new BGL	Sofia Bank	1 year	12 percent	Promissory notes	
Rousse	Complete construction of a housing project	1998	2.6 million new BGL	BulBank, UBB, but it has been transferred to Municipal Bank	3 years, with 1 year grace	6 percent	Houses and municipal promissory notes	Funds automatically withdrawn from Rousse bank account; Loan repaid in advance, after 1 year. Loan already repaid
	Credit overdraft	1998	500 thousand new BGL	Municipal Bank	1 year	7.5 percent	Current revenues	
Gabrovo	Road and street repairs	1998	900 thousand new BGL	DSK	1 year	11.00 percent fixed	Municipal revenue pledge / Additional guarantee with funds in privatization fund	Funds automatically withdrawn from Gabrovo bank account on loan due dates
Stara Zagora	Street repairs and construction	1998	1.4 million new BGL	BulBank	1 year	9.5 percent	Stock in Municipal Bus Transport Company valued at 3 million BGL new	Funds automatically withdrawn from Stara Zagora bank account on loan due dates Loan already repaid
Sevlievo	Purchase of energy saving street lamps	1998	250 thousand new BGL	Expressbank	1 year	10.74 percent	Pledge of youth center	Loan already repaid
Kazanlak	Priority costs	1998	500 thousand new BGL	Post bank	1 year	9.5 percent	Pledge of municipal property and municipal revenues	Loan already repaid

Name of Municipality	Purpose	Year Loan contracted	Amount of Loan	Bank(s)	Maturity	Interest rate	Collateral/ Security pledge	Other conditions/ Comments
Troyan	Priority costs	1998	540 thousand new BGL	Municipal bank	1 year	11.5 percent	Pledge of future revenues	Loan already repaid
Dupnitsa	Repair of youth center	1998	200 thousand new BGL	Central Co-operative bank	1 year	11 percent	Pledge of youth center	Repaid 160 thousand new BGL 40 thousand new BGL left for repayment

Municipal Bonds

Name of Municipality	Purpose of bond	Year bond issued	Amount of bond issue/ Currency	Par Value/ Issue Value	Financial intermediary	Maturity	Interest rate	Collateral/ Security pledge	Other conditions/ Comments
Sofia	Road reconstruction, tramway, and associated infrastructure projects	1999	50 million Euro		Parisbas (Luxembourg)	3 years	9.75 percent (LIBOR + 700 basis points)	No collateral	Issued on Luxembourg Stock Exchange
Svistov	Reconstruction of water supply system	1999	1 million new BGL/ 350,000 BGL minimum value	10,000 / 10,500	UNITY Invest	7 years, with 2 years deferred redemption	Basic BNB + 300 basis points, payable every 6 months; 7.46 percent initially (Dec.'99).	No collateral, payments are guaranteed by Svistov's own assets.	Only 30 percent purchased initially; subscription deadline extended.
Troyan	Reconstruction of water supply and sewerage system	Pending approval by SSEC	1.2 million new BGL		UNITY Invest	5 years, with 2 year deferred redemption	Basic BNB + 600 basis points payable once per year (initially about 10.5 percent (Dec'99).	No collateral, payments are guaranteed by Trojan's own assets.	

SOURCE: For loans, interviews with involved local officials and participating lenders. For municipal bonds, interviews with Sofia city officials and UNITY Invest for Svistov/Trajan bond issues, and bond prospectus for each project.



Of course, Sofia is idiosyncratic among Bulgarian cities, not only in terms of its sheer size, but also in terms of the relative health of its finances. No other Bulgarian city enjoys the name recognition of Sofia outside the country, and, few, if any, can afford the minimum size credit to justify the time and expense of underwriting an international offering.

Table III.1 chronicles only two attempts thus far (Svistov and Troyan, both promoted by the same financial intermediary) to offer a municipal bond to the domestic market. At this writing, (for reasons discussed in sub-section 3, below) only about a third of the Svistov bond issue has been sold, and the subscription date was extended. The Troyan issue remains in an advanced stage of preparation. We cannot comment on the financial soundness of these offerings. However, if successfully marketed, they would represent another step forward:

- These bond issues represent the first efforts to underwrite municipal bonds denominated in leva for the domestic market.
- The term of the bonds (seven years for Svistov and five for Troyan) extend well beyond those offered by commercial banks to date for their loans.

2. The Demand Side: Municipal Credit Demand and Investment Needs

As in all post-Communist CEE countries, Bulgarian local governments are faced with the challenge of remedying years of under-investment and under-maintenance in basic infrastructure and in building stock, and addressing stricter pollution control requirements. Water systems require major repairs to reduce leakage; wastewater systems require extension and upgrading; landfills need to meet new environmental standards; ancient public transport vehicles should be replaced; schools, health care facilities, administrative buildings made more energy efficient, etc. The list of urgent and pressing needs is formidable, and almost endless.

Local governments cannot afford to address the full extent of their investment needs, and at present they are legally limited to spending only 10 percent of MoF-defined own revenues on additional investment (above the amount of the targeted subsidy). There are also incentives, through the National Environmental Protection Fund, to focus on specific priorities, such as the National Waste Management Program (landfills) and the National Program for construction of wastewater treatment plants in smaller settlements. Local governments can obtain grant financing for 70 percent of project cost, and municipal enterprises, interest-free loans for up to 70 percent of project costs.

Thus, measuring effective demand for municipal credit will depend not on investment needs, but on capturing the readiness and the ability of local governments to take on and repay debt to finance their priority investments. One proxy indicator of such

demand is the aggregate annual level of municipal debt issuance in Table III.13 (in III.B.5, below): a total of 22 million BGN in 1998, of which only 15.6 million in bank loans. The 1999 planned borrowing of 106 million BGN comprises 95.6 million BGN in anticipated bank loans, of which 91.7 million by the city of Sofia (mostly for the city's Eurobond issued in the spring of 1999). The 1998 figures, of course, may understate demand since they exclude those municipalities that may have made overtures to banks over the course of the year, but that did not actually obtain financing.

By contrast, total municipal expenditures on investments in 1998 from both on- and off-budget sources reached 312 million BGN. (See Table III.14, in III.B.5, below). However, most of this investment is financed from either the targeted investment grant (126 million BGN in 1998) or from off-budget one-off privatization revenue. Only a fraction of the revenue available to fund local investment, once operating expenditures are taken account of, is recurring—that is reliably available many years into the future. By this measure, effective demand over the largest number of local governments is near nil—i.e., no matter how willing, most local governments cannot afford to borrow under the present financing system. This conclusion does not exclude, however, the possibility that there are a few municipalities with a stronger economic base, higher revenue diversity and income buoyancy which will enable them to form the base of an initially small municipal credit market. They would be the leaders for successful municipal credit initiatives, able to establish a track record of financing investments with medium-term loans and the capacity to repay these loans.

3. The Supply Side: The Willingness and Ability of Financial Sector Institutions to Hold Municipal Debt

Willingness to Lend—Creditor Perceptions. As suggested in the preceding section, no doubt the small volume of municipal debt issuance mainly results from the anemic borrowing capacity of the local governments themselves—the lack of effective demand. To a lesser extent, the overall conservatism of the financial community, and the banking sector itself, has contributed to this result. Bankers are reluctant to lend regardless of purpose or type of borrower. At present the financial system exhibits quite high liquidity, with institutions content to hold a disproportionate portion of their assets in short-term, low-risk central government securities and commercial paper. As of July 1999, less than 30 percent of total bank assets were allocated to credits as compared with upwards of 80 percent in most developed economies.⁸ This caution reflects attitudes formed in the relatively recent financial crisis, and re-enforced by Bulgarian National Bank policies and the criminal code (as discussed in Chapter IV.E.2, *Other Financial Sector Laws and Regulations*, below. Moreover, interviews for this study revealed additional lender concern about the unique political risks of longer term lending to municipalities, and some skepticism about the immediate business opportunity:

⁸ For Bulgarian banks, Bulgaria National Bank Bulletin, June 1999. The same bulletin showed overall liquidity in the banking system (as measured for the purpose of BNB regulation of reserves) at over 55 percent.



- Bankers rightly recognize that few municipalities have budgets that reliably generate the operating surpluses needed to service debt.
- Many banks are leery of making longer-term loans that extend beyond the tenure of the existing mayor and council. In the event of a change in the political composition of the local government's leadership, they wonder whether the incumbents would honor the debt obligations taken on by their predecessors in office.

No doubt, the paucity of municipal loans reflects lender inexperience in identifying bankable municipal projects and underwriting local governments. For example, few banks seem to have considered alternatives to physical collateral for securing repayment.

That said, virtually all the bankers interviewed for this study recognized that over the years ahead they will have to allocate more of their portfolios to credits and evidenced an interest in municipal lending as a future line of business. The larger banks maintain local branch offices and consequently are familiar with local finances, particularly those banks that service the day-to-day banking needs of local governments.

Like the commercial banks, both the pension funds and insurance companies find themselves in a highly liquid position as well. Reportedly, over 90 percent of pension fund assets are invested in state securities. As of the end of 1998, for Non-Life Insurance Firms, over 76 percent of their reserves were held in bank deposits and another 13 percent in state guaranteed securities. For the Life Insurance firms, the comparable figures were about 38 percent of reserves in bank deposits and 57 percent in state securities.⁹

Both pension and insurance company officials, within the stricter legal constraints on their investments, perceived municipal lending as an opportunity for realizing somewhat higher yields in exchange for accepting some increased risk (as opposed, for example, to simply rolling over treasury notes). One major pension fund and one insurance fund were reportedly among the initial subscribers to the Svishtov bond issue. Pension funds also invested in the Sofia Eurobond issue. As a result of lack of investment options, municipal bonds may present an attractive investment instrument for fund managers.

The Potential Supply of Funds. For the near term, the potentially available supply of capital itself does not pose a constraint on the enlargement of municipal credit market activity. Table III.2, below, shows the volume of assets held by commercial

⁹ Figures for pension industry from interviews with industry officials. For the insurance industry, 1998 Annual Report of Insurance Supervision Directorate (Sofia, 1999).

banks, the pension system, and the insurance industry. These are the three classes of institutions most likely to supply capital to the municipal credit market. As can be seen, at the present time, banking system assets dwarf those of the other institutions.

Table III.2: Possible Sources of Municipal Credit

Type of Institution		Illustrative Capital for Municipal Sector		
		Total Assets (Thousand BGN)	Percent of Assets	Thousand BGN
Commercial Banks		7,483,696	2	149,674
Pension Funds	Pillar II ^a	—	5	—
	Pillar III	87,160	5	4,358
Insurance	Non-Life Assets	261,355	5	13,067
	Life Insurance	178,219	5	8,910
Total		8,010,430	2.2	176,009

^a Deposits for the 2nd Pillar are expected to begin in the year 2000

Sources: Bulgarian National Bank Monthly Bulletin (1999); USAID Bulgarian Pension Reform Project (1999); Bulgarian Association of the Additional Pension Security Companies (1999); 1998 Annual Report of Insurance Supervision Directorate.

However, Bulgaria has recently begun to implement a three pillar, pension system reform, which could bring significant funds into a municipal bond market in the not too distant future. Pillar Three (voluntary private pensions) was authorized by the *Supplementary Voluntary Pension Insurance Act 1999*. Pillar Two (mandatory private pensions) is being introduced gradually and will be applicable to the entire labor force in the Year 2004.

Table III.3 shows projections for the growth of assets in Pillar II and III funds respectively from 1999 through 2005.

In both Tables III.2 and III.3, the right hand column provides an illustrative and somewhat arbitrary indicator of the magnitude of funds that could flow into municipal credits from each class of institution. This illustration assumes somewhat arbitrarily that 2 percent of bank assets and 5 percent each of insurance fund reserves and pension assets might become available. This equates to just over 2.5 percent of all assets given the preponderance of bank assets in the total. By comparison, in the Czech Republic between 2.5 percent and 3 percent of total capital market assets are committed to the municipal sector; in the US, the comparable figure is about 10 percent.

As can be seen, the illustrative potential supply of municipal credits far exceeds the aggregate municipal loans identified above as issued in 1998—even more decidedly if the Sofia borrowings are excluded.



Table III.3: Projected Pension Assets of Pillar II and III (1999-2005)

Thousand BGN								Illustrative Capital for Municipal Sector
	1999	2000	2001	2002	2003	2004	2005	5 percent of 2005 assets
Pillar II	—	34,154	70,914	110,213	151,064	270,459	400,851	20,042
Pillar III	87,160	149,500	217,750	299,395	397,777	515,248	656,392	32,819
Total	87,160	183,654	288,664	409,608	548,841	785,707	1,057,243	52,862

Sources: Pillar II projections from Bulgaria Association of the Additional Pension Security Companies; Pillar III projections from USAID Bulgarian Pension Reform Project.

In respect to the number of relevant financial sector participants that could potentially make the markets for municipal bonds, at present there are:

- 34 commercial banks, with about 55 percent of the assets in the banking system held by just three institutions (BulBank, DSK Bank—the former State Savings Bank, and United Bulgarian Bank).
- 11 institutions in the Association of Private Pension Funds, with six of the older funds controlling roughly 80 percent of assets in the voluntary Pillar III system to date.
- 31 insurance companies (13 in life insurance; 18 in non-life lines of business). One life insurer (the State Insurance Institute-DZI¹⁰ EAD) dominates that segment of the industry, with over 83 percent of the assets; the non-life sector is more competitive, with the largest participant holding only 30 percent of the assets, and the next two largest less than 15 percent each.¹⁰

Despite the presence of dominant firms, given a country of Bulgaria's size there would appear to be reasonable prospects for competition among institutions on the supply side of the municipal credit market once it begins to coalesce.

Comparative Yields. Municipal (and MOC) debt instruments will have to compete for investors with other investment products that offer different yield curves and differing levels of risk and uncertainty. Table III.4 shows the 1998 and 1999 yields on Bulgarian Treasury bills of differing maturities. Table III.5 shows the BNB's July 1999

¹⁰ Figures for commercial banks derived from *BNB Monthly Bulletin*, June, 1999; for the Pension industry, from interview with the director of the Association of Private Pension Firms, and for the Insurance Industry, the asset distribution from the *1998 Annual Report of the Insurance Supervision Directorate* and the number of firms from an interview with the Directorate's Executive Director (Note: the number of insurance firms cited here represents an increase from 1998 with the recent entrance of some foreign participants.)



comparative figures for interest rates within the banking system and yields for government securities.

Several financial sector officials interviewed observed that one reason the Svistov bond issue had trouble finding buyers was that the coupon rate was only 300 basis points above the BNB's bank rate, less than the return available on lower risk government securities with much less risk and shorter maturity. Clearly, much more transactional experience will be needed before intermediaries can gain confidence in pricing municipal bonds at levels where they can find a ready market. For the near term, the yields on one to five year sovereign debt will establish the *de facto* benchmark from which prices for higher risk, municipal debt will be derived.

Table III.4: Treasury Bond Yields

Type of Bond	1999 Average yield	1998 Average yield
Three-month treasury bonds	4.75	5.33
Six-month treasury bonds	5.03	5.85
One-year treasury bonds	6.29	7.25
Two-year treasury bonds	10.16	10.34
Three-year treasury bonds	N/A	11.92
Five-year treasury bonds	13.21	13.81

Source: Stoyan Alexandrov, Municipal Finance Consultant

Table III.5: Interest Rates and Government Security Yields, July 1999

Type of Credit	Interest Rate or Yield
Base Interest Rate	4.83
Short-Term Interest Rate on BGL Credits	13.79
Yield on Short-Term Government Securities	5.13
Long-Term Interest Rate on BGL Credits	15.4
Yield on Long-Term Government Securities	10.74

Source: BNB Monthly Bulletin, 7/99

Conclusion: In the near term, the commercial banks will most likely continue to be the most important source of debt financing for Bulgarian municipalities. However, as assets accumulate in both Pillars II and III of the pension system, and as a more mature market comes to accept longer-term maturities, pension monies could conceivably overtake the commercial banks as the leading source of municipal credit. One reason for this conclusion is that the longer-term liability structure of pension funds is a better match with long-term municipal debt. Commercial bank liabilities are typically quite short-term. Over time, the banks' role may rest on the emergence of a viable secondary market in municipal credit which would let them act more as intermediaries who would originate municipal credits for resale rather than to hold in their portfolios as investments. Finally one should make note that private placement of municipal bonds



(with both financial sector institutions) may play a significant part in the formative stage of the municipal credit market, as it has in Poland.¹¹

B. Municipal Creditworthiness

1. Economic Health

The economic health of local governments has a direct impact on their creditworthiness. If local revenues do not keep pace with or exceed the trends of local expenditures, the capacity to increase investment (including through loan financing) will be considerably restricted.

During the transition period, changes in their respective roles and financing has led to a reduction of the share of both the central government and the local governments in the economy. Local government expenditures have borne a greater loss in respect to GDP than the national government, despite the important role of Bulgarian local governments in key social sector areas, such as education, health and social assistance. This trend was compounded by Bulgaria's fiscal crisis in 1996-1997. From 1991 to 1997, the share of municipal expenditures in GDP has declined from 11 to 5.8 percent and their share in general government expenditures from 22 to 17 percent.¹²

Table III.6: Share of Local Government Expenditures in GDP/General Government (in Percent)

	1995 actual	1996 actual	1997 actual	1998 estimate
GG ¹³ / GDP	42.4	45.2	34.1	
LG ¹⁴ / GDP	7.7	6.3	5.8	7.7
LG / GG	18.2	14.0	17.0	

Sources: *Local Finance*, Stefan Ivanov; IMF/Government of Bulgaria data.

Nevertheless, initial estimates for 1998 indicate that there has been a recovery in municipal finances, which may indicate an increase of up to 2 percentage points of local share in GDP. This is due to two main factors. First, there was an overall increase in collections of taxes, which are shared with local governments, the personal income tax (PIT) and the corporate income tax (CIT) (although their share in total local revenues

¹¹ Here it is relevant to note that although the Sofia Eurobond was publicly listed on the Luxembourg, exchange, the portion (18 million of the total 50 million euro) marketed within Bulgaria was placed on a private basis.

¹² General government includes the consolidated budget (republican budget, budgets of Ministries, local governments, social security fund), as well as all extra-budgetary funds and accounts of central and local government levels.

¹³ General government

¹⁴ Local government

declined in 1998). Second, 1998 was the first year of implementation of the changes to the Law on Local Taxes and Fees. As a result, the share of local taxes in total revenues increased to 4.9 percent, from 2 percent, and local fees almost doubled their share, from 3.2 to 6.2 percent (Table III.7). However, this buoyancy is not likely to continue, as there is no automatic adjustment of local tax bases and fee rates for inflation.

Table III.7: Structure of Local Government Revenues

Percent of total revenues	1996 actual	1997 actual	1998 actual	1999 budget
General transfers	30.4	31.4	30.5	23.0
Shared PIT	31.4	33.9	30.3	32.0
Shared CIT	13.2	20.8	15.3	16.0
Local taxes	5.4	2.0	4.9	5.2
Local fees	4.9	3.2	6.2	6.8

Sources: *Data of the Ministry of Finance, Stefan Ivanov.*

Despite improved revenue collections, the overall situation and balance of local governments is quite negative. The current presentation of Bulgarian municipal budgets adds together all revenue sources and all expenditures. Although this approach shows an end-of-year result, it does not provide sufficient information on local capacity to finance investment from own sources and/or to finance loan repayments. In addition, local government budget results are presented on a cash accounting basis, which is a significant limitation, considering the high level of unpaid liabilities remaining each year in local balances.

In order to analyze the creditworthiness of Bulgarian local governments in the aggregate and by six population groups, using actual municipal budget data for 1996 to 1998 and the budget for 1999, we separated revenues and expenditures in the municipal budget classification into the “current” or “operating” budget and the “capital budget”. (The detailed tables by population group are included in Annex D.)

By separating the current from the capital budget, it becomes possible to illustrate whether Bulgarian local governments can or cannot generate a net operating surplus (current revenues minus operating expenditures minus debt payments), which would enable local governments to finance investment from their recurring revenue sources, as well as to finance debt payments for loans contracted for investment purposes. Nevertheless, in light of the use of cash accounting, the extent of unpaid liabilities, and the importance of off-budget funds (such as the Privatization Fund and the Environmental Protection Fund), we calculated several other intermediate balances to illustrate the financial situation at the local level (these are described in Box III.1, below).



BOX III.1: LOCAL GOVERNMENT BUDGETS—CREDITWORTHINESS ANALYSIS APPROACH

This box describes how local government expenditures and revenues were separated into a “current” budget and a “capital” budget, as well as how the intermediate balances presented in Table III.8 are calculated.

Total current revenues

= Total shared revenues + Local taxes + Local fees + Current net transfers + Other current local revenues
Other current local revenues
= rents of municipal property, interest earnings, dividends, penalties, concessions and other

Total current expenditures

= wages/social security + materials/services + current transfers/subsidies + interest payments

(1) Gross operating savings

= Total current revenues - Total current expenditures

(2) Net Operating Savings

= Gross operating savings - principal payments on debt and securities

Total Capital Expenditures

= Renovation/rehabilitation + capital equipment purchases + share purchases + subsidies for capital investment

Total Capital Income

= Own capital revenues (sales of municipal assets) + Target subsidies for capital investment

(3) Balance after Investment

= Net Operating Savings – Total Capital Expenditures + Total Capital Income

(4) Expenditures / revenues balance (incorporates financial transactions and borrowing)

= Balance after Investment + Loans contracted +/- Financial transactions

(5) End of year Budget Balance (incorporates unpaid liabilities and cash on hand / in bank accounts)

= Expenditures / revenue balance + Deposits in bank accounts – Unpaid expenditures left at end of year

(6) Consolidated end of year Balance (incorporates off-budget funds)

= End of year budget balance + targeted subsidies for environmental projects + Off-budget balance

Off Budget Balance is the net result of revenues minus expenditures for all off-budget funds, including the Privatization Fund.

Table III.8: Local Government Budget Balances – Aggregate for all municipalities

<i>Million old leva</i>	1996 actual	1997 actual	1998 actual	1999 budget
(1) Gross operating savings	4,188	34,500	52,138	31,565
(2) Net operating savings ¹⁵	3,348	34,192	50,710	31,565
Percent of current revenues	3.2	3.6	3.4	1.9
(3) Balance after investment	-1,519	8,865	-19,530	-62,573
(4) Expenditure/revenues balance	652	12,136	2,487	-16,301
(5) End of Year Budget Balance	-10,932	-11,047	-58,075	—
Percent of total revenues	-9.8	-1.1	-3.5	
(6) Consolidated End of Year Balance	-5,654	27,463	-5,093	11,373

Source: Calculated from data of the Ministry of Finance, Stefan Ivanov

As the summary of results indicates, overall, for all local governments, net savings capacity is minimal and does not allow for significant financing of local government investment or debt. The average for all municipalities in 1997-98 is 3-4 percent of current revenues, compared to 40 percent in the Czech Republic, and 15-25 percent in Poland and in France, all countries where local governments have been able to make significant efforts in improving local service provision and infrastructure.

The results of final balances, once investment, loans and other financial transactions are accounted for, are of additional concern. The expenditures/revenues balance (4), which incorporates borrowing and financial transactions, does not allow for much of an end of year surplus. The end of year budget balance (5), which accounts for unpaid expenditures shows a deficit, which has varied widely in terms of total revenues (-3.5 percent in 1998). Even the balances available in the extra-budgetary accounts, incorporated to establish the end of year balance (6), were not sufficient to off-set the budget deficit in 1996 and 1998.

In 1999, the budgeted end of year budget balance (5) of local governments was ensured only by the deposits on bank accounts. This means that in order to come up with a balanced budget, the local governments had to count on funds in the bank carried over from the previous year, as anticipated current year 1999 revenues were insufficient.

Local budget data was also analyzed by five population groups, plus the city of Sofia. Table III.9 illustrates the net operating savings ratio (2) and the end of year budget balance (5) (as a percent of total revenues) for each of the population groups. The smallest towns and villages generated relatively high levels of net savings in 1996

¹⁵ For some reason, the 1999 budget plan does not include an estimate for loan repayments during the year.



and 1997, which by 1998 had been reduced to almost nothing, due to considerable increases in operating expenditures. At the other end of the population scale, the changes in 1998 increased the net savings capacity of the capital city. In between, there is a range of savings from less than 1 to 5 percent of current revenues. For the 1999 budget, the four groups with smallest population are in negative net savings, which signifies that operating expenditures are being financed either from capital revenues, or bank deposits carried over.

The end of year budget balances (which incorporate unpaid expenditures remaining at the end of the fiscal year) further illustrate the very precarious financial situation of Bulgarian local governments. Almost all population groups registered negative balances in 1996, 1997 and 1998. The exception is Sofia, with a positive balance since 1997. The largest cities are showing deficits of more than 5 percent of total revenues. These results suggest that there is an inherent overall under-funding of the municipal sector. The rules which guide local government budget preparation and financial management serve to worsen this situation¹⁶, including the determination by the central government of priority current expenditures and the limit on investment spending to 10 percent (5 percent as of 2000) of MoF-defined own revenues.¹⁸

A significant change was implemented in 1999, as most of the off-budget funds (with the exception of the Privatization Fund and the Environmental Protection Fund) have been brought on-budget. The end of year budget balance may thus be improved in appearance. Nevertheless, most of these revenues are targeted to specific uses, and will not address or directly improve the imbalance of the municipal sector.

¹⁶ Article 6(2) of the Municipal Budgets Act (MBA) of 1998 provides a definition of local own source revenues which includes: corporate income tax ("municipal tax"), local taxes, local fees, rents of municipal property, interest earnings, dividends, penalties, concession income, other local revenues, sales of municipal assets. Shared PIT is referred to in Article 6(3) as "transfers of public revenue". Indeed, the annual State Budget Act (Article 9, in 1999) refers explicitly to Article 6(3) to set the share of PIT allotted to local governments. However, the practice of MoF does not respect the legal definition of the MBA, and MoF appears to include the share of PIT in the definition of own source revenues, including in the denominator to estimate the investment limit as 10 percent of own source revenues. In this report, MBA-defined own revenues refers to the definition of the Municipal Budget Act, with PIT not included and MoF-defined own revenues refers to the definition of own revenues retained by MoF, with PIT included.

¹⁸ This issue is discussed in Sections 2 (budgeting and financial management systems) and 3 (central government financial controls), below.

Table III.9: Local Government Budget Balances – By Population Groups

Population groups (inhabitants)	1996 actual	1997 actual	1998 actual	1999 budget
(2)Net operating savings (percent of current revenues)				
0-10,000	12.3	12.6	1.8	-2.3
10-20,000	3.2	4.3	2.3	-2.6
20-50,000	1.8	5.7	2.3	-1.0
50-100,000	3.0	1.4	-0.2	-3.2
>100,000 (except Sofia)	0.8	0.7	3.3	4.0
Sofia	5.3	3.5	8.8	8.7
(5)End of year Budget Balance (percent of total revenues)				
0-10,000	-9.7	1.4	-2.6	0.0
10-20,000	-10.4	1.0	-2.3	0.0
20-50,000	-10.1	-0.2	-3.5	0.0
50-100,000	-10.6	-1.7	-4.0	0.0
>100,000 (except Sofia)	-14.2	-6.1	-7.8	0.0
Sofia	-1.6	3.0	1.7	0.0

Source: Calculated from data of the Ministry of Finance, Stefan Ivanov

Establishing the base of a municipal credit market does not, of course, require that all local governments be creditworthy. Within each of the population groups, there are a few local governments with a stronger financial base, dynamic local economy and the capacity to contract and repay debt for priority municipal investment projects. Nevertheless, the fact that net savings levels are so low in the averages clearly points to the overall financial weakness of the municipal sector.

2. Adequacy of Local Budgeting and Financial Management

Bulgaria has put into place a series of laws, which regulate the preparation, and implementation of local budgets.¹⁹ Although the Municipal Budgets Act is quite recent and appears to have been prepared in consultation with international donor organizations, there are still a number of important weaknesses in regard to ensuring adequate budget management and promoting good financial accounting procedures. The disincentives to good financial management are further compounded by some of the specific rules included in the Annual State Budget Act.

For the past two or three years, the starting assumptions on which local budget preparation and implementation is based are in fact flawed; these assumptions inevitably lead to end of year municipal deficits, which though less acute than in 1996, have continued to persist (Tables III.8 and III.9). There are three aspects, which interact and in some ways, reinforce each other.

¹⁹ The most important of these are the National Budget Procedures Act of 1996, the Municipal Budgets Act of 1998 and annual State Budget Acts for the Republic Budget.



First, local governments are allowed to plan for a deficit of up to 10 percent of expenditures when preparing their budgets.²⁰ This refers to an overall deficit, and there is no distinction if the deficit is related to financing general operating expenditures, or to the financing of municipal investment projects.²¹

Second, the general subsidy given to local governments in fact is only distributed up to 90 percent of the amount allocated²²; however, municipalities are likely budgeting based on the assumption that they will receive the full 100 percent of the transfers that have been announced and published in an annex to the budget. In the 1999 budget plan, transfers from the central government accounted for close to 28 percent of total revenues for all local governments; thus, there is a minimum additional 3 percent deficit being created at the local level, and which is higher for the smaller towns (up to 50,000 inhabitants), where transfers account for 40-50 percent of revenues.

Finally, end of year unpaid liabilities are carried over without being identified specifically within the budget.²³ Although the statements prepared by MoF record these unpaid liabilities, at the local government level they are merely budgeted as new expenditures for the following budget year. This treatment of the unpaid liabilities has a number of consequences: the overall imbalance of municipal budgets is not addressed in an up-front manner. If previous year liabilities are paid in full, and there is not much change in local revenue, the imbalances in fact get pushed to the end of the following year, and re-carried over again. As Table III.10 below illustrates, unfunded expenditures have increased from 11.5 billion old leva in 1996 to 74 billion leva in 1998. Although, this amount is now less than 10 percent of total revenues, it was still recorded at more than 4 percent in 1998. This is an inherent problem which combines a lack of sufficient revenues for local governments to carry out the responsibilities they have been given and a lack of incentives and hard budget constraints for local governments to manage their finances in a responsible manner.

Thus, although the Municipal Budgets Act requires local budgets to be prepared according to principles of lawfulness, economy, expediency, effectiveness and efficiency (Article 4), they are not required to be either in balance or real, as is the case in France and Romania (see Box IV.9).

Table III.10: Unfunded expenditures for all local governments by population category

²⁰ Article 10(1) of the Municipal Budgets Act.

²¹ This issue is further discussed below, in Section 3 on central government financial controls.

²² This restriction is included in the annual State Budget Acts of 1998, 1999 and 2000, for all state expenditures, and is related to Bulgaria's agreement with the IMF (see paragraph 6 of the Memorandum on Economic Policies of the Government of Bulgaria, accompanying the Letter of Intent to the IMF, August 20, 1999), as an element of fiscal policy. The remaining 10 percent would be distributed only if the planned budget deficit is not exceeded.

²³ The unpaid liabilities are recorded in the accounting balance sheet; but there is no direct link between the balance sheet and the budget; it is the latter which defines the fiscal and financial policies of the local government for the fiscal year and which is used in managing and implementing local government activities.



<i>Population groups</i>	1996 actual	1997 actual	1998 actual	1999 budget
Unfunded expenditures (million leva)				
0-10,000	830	733	4,303	
10-20,000	1,538	1,277	7,052	
20-50,00	2,262	2,316	12,363	
50-100,000	2,326	4,486	12,700	
>100,000 (except Sofia)	4,204	14,997	38,024	
Sofia	424	—	—	
All local governments	11,584	23,809	74,442	
Unfunded expenditures (percent of total revenues)				
0-10,000	11.2	1.0	3.9	
10-20,000	11.6	1.0	3.7	
20-50,000	10.8	1.2	4.1	
50-100,000	11.2	2.5	4.7	
>100,000 (except Sofia)	14.3	5.9	8.4	
Sofia	2.1	—	—	
All local governments	10.4	2.4	4.4	

Source: Calculated from data of the Ministry of Finance, Stefan Ivanov

Local budgets must be prepared in line with the classification of revenues and expenditures according to the nomenclature of the Ministry of Finance, and implemented according to specific annual rules of the State Budget Act. The budget does not distinguish between an operating section and an investment section, and is implemented on a strictly annual basis, with no multiyear investment plans.²⁴ Combined with the central government limits on investment spending by local governments, this system discourages setting aside funds for future investment. The lack of multi-year planning perspective for investments is further reinforced with the practice of allowing the targeted investment subsidy to be transformed into a general subsidy at the end of the year. Investments which are started by a local government are not ensured of being financed the following budget years, and an entirely new application to obtain the additional financing must be made each year.

²⁴ The Municipal Budgets Act does require the municipal budget projection to outline the parameters of the municipal budget for the following three years (Article 11.(1)2); but this is not then related to implementation of the budget, financing of investments through guaranteed multi-year allocations, etc.



3. Central Government Financial Controls

Through various legislative texts, the central government has imposed controls and limitations on both local government revenue raising capacity and in local expenditure choices and priorities. The impact of these limits is to restrict local decision-making authority, and by extension, increase the disincentive to responsible municipal financial management. In this sense, a lesser awareness of financial responsibility may not improve the overall level of local creditworthiness.

The share of revenues over which local governments exert some level of control or decision-making amounts to only 10 percent of total revenues (excluding borrowing). The types of revenues included in this calculation are local fees, other current revenues, and own capital revenues.

Municipalities have no authority over local taxes, which include the property tax, inheritance tax, gift tax and vehicle tax. Assessment, tax rates, and exemptions are defined in the Local Taxes and Fees Act. The revenue from these taxes is collected by the tax administration authority of MoF, and remitted to the local budgets. One of the barriers to allowing local determination of tax rates is the Constitutional provision requiring tax rates to be set by law. Although there have been proposals to transfer tax collection and administration responsibility to local governments, doing so without the transfer of rate authority will give the appearance of greater local autonomy, but will not increase revenue yields. Local governments do not have adequate capacity to take on the burden of tax collection and administration, and reform efforts should focus on giving local governments more tax and fee rate setting authority.

There is somewhat more scope for local decisions regarding local fees. Most fees (such as for market places, kindergartens, resorts, dog fees, etc.) are assigned a range of rates (with floor and ceiling limits), with the municipal council responsible for setting the rate to be applied locally. Most of these fees are collected directly by the municipal administration. Finally, there are no constraints in setting the garbage fee²⁵ (which is based on a cost-recovery principle), rents of municipal property and sale price of municipal property. Nevertheless, the fact that the floor and ceiling rates are set in the Local Taxes and Fees Act, without provision for an automatic adjustment for inflation, means that Parliament must amend the law in order for these revenues to keep up with economic adjustments and with changes in the cost of providing the related services.

On the expenditure side, regulations define the spending priorities for local governments, limit allowable investment spending and indirectly, limit total amount of borrowing. The Annual State Budget Act defines the funding priorities for municipalities, as funds are available (Article 13(3) and Article 14(2)). These priorities are, in order of

²⁵ The garbage fee is assessed on the same tax base as the property tax, but the revenues collected in 1998 were twice as high.

their appearance: medications (including free supply for outpatients), salaries, scholarships, pensions, social security compensations and benefits, food, heating, electricity, as well as maintenance of social, health care and educational establishments. One interpretation of this priority list is that it constitutes an indirect recognition of the under-funding of the municipal sector, relative to the responsibilities which have been assigned to it in the Local Self Government and Local Administration Act, and in the Municipal Budgets Act.²⁶

In order to ensure that municipalities adhere to the priority spending sectors, the central government has imposed an additional limit on investment spending; beyond the investments financed through the central targeted investment subsidy, local governments are limited to “additional” investment spending of only 10 percent of MoF-defined own revenues (reduced to 5 percent in the 2000 budget).

As discussed in the previous section, a further limitation on local government expenditures is the fact that the MoF only distributes 90 percent of the budgeted amount of central government transfers.

All in all, given the different types of requirements, it has been estimated that of the total expenditures managed by local governments, they have full local control of less than 20 percent of the total. The remaining 80 percent are expenditures for which local governments have only shared control or limited control.²⁷

There are no direct limits on borrowing by local governments, but an indirect limit, based on the allowable deficit, up to 10 percent of total revenues (and the latter is more properly viewed as a facility or advantage to the local governments, rather than as a form of control).

4. Revenue Stability and Predictability

Achieving revenue stability in a period of economic crisis and hyperinflation is a feat. Revenue stability enhances local government creditworthiness, as lenders and investors are more or less certain that sufficient funds for loan repayments will be available. For local governments, revenue stability implies several conditions, and two of the most important are that local governments have some control over the revenues which accrue to them, and for the revenues over which they have no control, that the rules and amounts remain relatively constant and known to all.

Local revenue sources are defined in the Municipal Budgets Act and consist of MBA-defined own source revenues (Article 6.2 - local taxes, local fees, income from

²⁶ Though it should be noted that priority order of expenditures has also been defined for all other sectors of general government.

²⁷ Emil Savov, “Identify issues related to the existing condition”, Draft “A-Series” Report, Bulgaria LGI. 1999.



concessions, fines and penalties, interest income, rents), transfers of public revenue (essentially, the shared PIT - Article 6.3), and grants / subsidies from the central budget (Article 6.4).

For Bulgarian local governments, current revenues and current expenditures have increased in real terms over the period 1996 to 1999, with a significant increase in 1998. This was due to changes in the Local Taxes and Fees Act, which in 1997, increased applicable rates and charges, and to the buoyancy of revenues from shared PIT.²⁸ As local taxes and fees rates are determined by law (except for the garbage fee), further increases in local taxes and fees revenues will depend on the extension of the related activities, or on the increase in users.

Table III.11: Revenues of Local Governments

Million BGL	1996 actual	1997 actual	1998 actual	1999 budget
CURRENT REVENUES	105,114	945,414	1,499,777	1,679,249
– Current net transfers	33,303	305,794	487,846	435,908
– Shared revenues	53,946	557,087	775,310	911,296
– Local taxes	5,973	20,338	82,992	97,349
– Local fees	5,409	31,754	104,162	126,935
– Other current revenues	6,483	30,441	49,467	107,761
CAPITAL REVENUES	4,198	54,020	141,810	117,449
– Own capital revenues	995	10,720	15,512	35,571
– Targeted transfers	3,203	43,300	126,298	81,878
FINANCING	2,172	3,897	35,897	62,574
BORROWING / BONDS	2,150	3,267	22,017	106,273
FINANCIAL TRANSACTIONS	22	5		-60,000
DEPOSITS IN BANK ACCOUNTS		625	13,880	16,301
TOTAL BUDGET REVENUES	111,484	1,003,331	1,677,484	1,859,272
OFF BUDGET REVENUES²⁹	24,735	163,944	272,826	
– Off-budget current revenues	15,154	103,679	154,881	
– Off-budget capital revenues	9,109	58,415	111,682	
– Targeted environmental transfers	472	1,850	6,263	11,373

Source: Calculated from data of the Ministry of Finance, Stefan Ivanov

The two main national taxes shared with local governments are the personal income tax (PIT) and the corporate income tax (CIT). The share of the PIT allotted to local government is defined each year in the State Budget Act. To date, this share had

²⁸ James S. McCullough, "Analysis of Municipal Financial Condition in 1998", Research Triangle Institute.

²⁹ Most off-budget funds were integrated into the main local government budget in 1999, with the exception of the Privatization Fund and the Environmental Protection Fund.



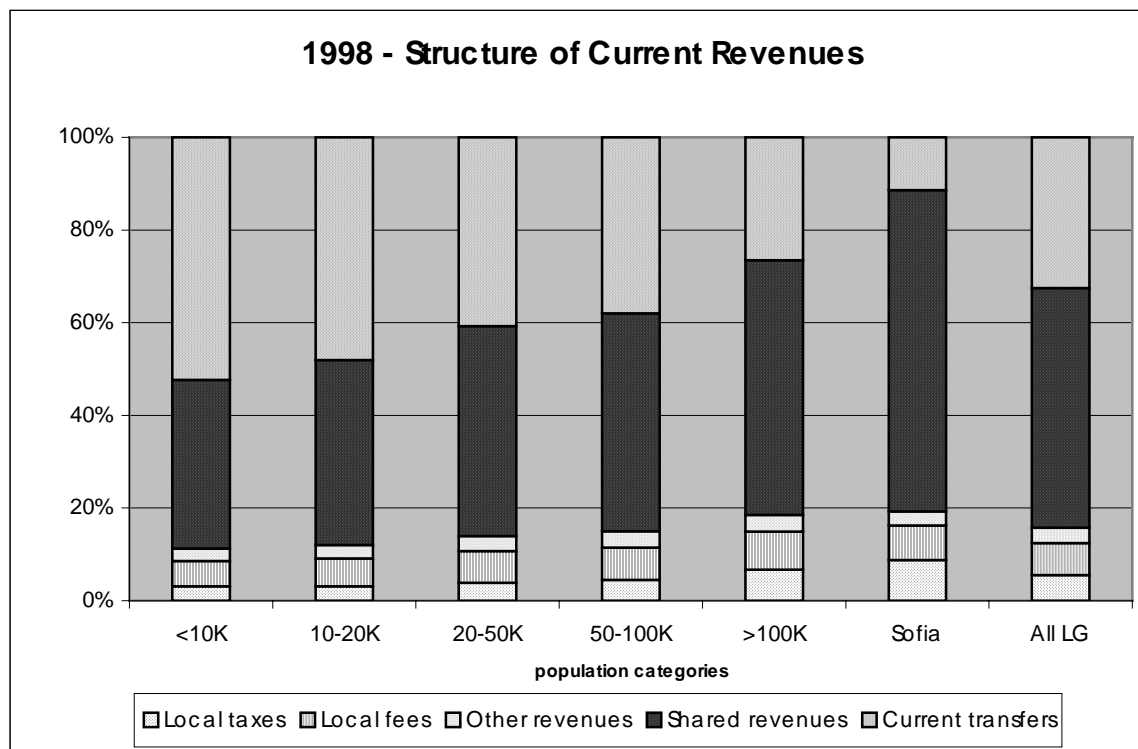
remained stable, at 50 percent of PIT revenues. The municipal share of the CIT is a 10 percent additional rate on this tax, known as the “municipal tax”, and is defined in the Corporate Income Tax Act. This additional rate has also remained the same, except for a short period in 1996, when it was temporarily reduced to 6.5 percent.³⁰

An initial conclusion is that stability exists in terms of shared taxes, this stability seems to have held for the past three years, and will continue as long as the share allotted to local governments is not arbitrarily reduced. If such a decision were to be taken (which appears unlikely for the moment) and if the Government did not act to replace or compensate a lowered share with another source of funding, then local government finances would be seriously compromised. In terms of local taxes and fees, for as long the tax and fee rates are fixed in law, without an automatic adjustment for inflation, there will be a loss of income to local governments. The hyperinflation of 1996-1997 was greatly detrimental to allowing local taxes and fees to keep up with price changes. In 1998 and 1999, annual inflation was less than 2 percent. Although this will not greatly impact on local tax and fee collections and loss of value for these two years, as a general principle, a framework which does not build in a system to automatically adjust tax bases, or allow for local decision on tax/fee rates, is not adequate to ensure a certain level of local government revenue stability and buoyancy.

As Chart III.1 illustrates, the smallest local governments depend on the general transfers for about 50 percent of their current revenues, while this share is less than 30 percent in cities with more than 100,000 inhabitants, and less than 10 percent in Sofia. The largest municipalities receive a larger proportion of their revenues from the shared taxes (over 50 percent, and 70 percent in Sofia) and have a greater base on which to collect own local taxes and fees. As a result, the smallest towns and municipalities will be more sensitive to changes in the formula to distribute the general transfers, while an economic downturn, which negatively affects personal and corporate income will have a greater negative impact on the largest municipalities.

³⁰ Note that the Municipal Budgets Act (Article 6.2) includes the municipal share of CIT (“municipal tax”) in the definition of own revenues.

Chart III.1: Structure of Current Revenues in 1998, by Population Category



Transfers from the central government include the general transfer, a special transfer for social welfare expenditures (instituted in 1999) and targeted grants for investment. The main funds distributed by the central government is the general transfer. The MoF sets the overall level of the transfer and claims that it is no longer in the role of direct guarantor of the deficit. The distribution of funds is based on a formula, first established in 1993, which incorporates objective criteria to finance expenditure needs, a leveling out fund to ensure a measure of equalization, and allocations to account for specific situations (e.g., municipalities in a critical situation, fund to adjust wages and social benefits, etc.). The leveling out fund includes contributions from local governments, but there are fewer than 10 that contribute to the pool.

Over the years, the formula has become more complex, as the number of objective criteria were increased from 5 to 27, in an attempt to express all the expenditure needs of local governments. In the end, the objectives are often ignored and the system is managed manually, leading to more ad hoc decisions.

Several analyses indicate that the subsidies operate well to identify local governments with very low own revenue per capita, which is an indication that the system is at least achieving an objective of equalization.



Recent studies have identified at least four priorities for changes to the transfer system, which will serve to increase the transparency, stability, and predictability of the system.³¹ These priorities are: a) establish a new system of objective criteria; b) implement a clear allocation methodology, with independent implementation of the formula and institute effective monitoring; c) include elements for equalization on a horizontal basis; and, d) provide legal guarantees for the regularity and full disbursement of the subsidy transfers.

5. Sources of Investment Finance

Since the transition, investment spending by Bulgarian local governments has been extremely low, and is insufficient to meet the economic and development needs of local governments, make up for lack of maintenance of existing infrastructure (such as the very high levels of leakage in the water systems), and begin to meet European standards for environmental protection. As Table III.12 below illustrates, on-budget capital expenditures only account for 10-12 percent of total expenditures (and less than 10 percent before 1998). This rate does not compare favorably with other transition countries such as Hungary (18 percent), Poland (more than 20 percent) and the Czech Republic (more than 30 percent).

Sources of financing available for investment are quite limited, and consist of own sources (essentially revenues from sales of municipal assets³²), targeted subsidies, net savings from the operating budget³³, and resources from borrowing and other financial transactions. Off-budget sources are also available to finance local investments. As illustrated in Table III.12, in 1996 and 1998, the sum of net savings, own capital revenues and targeted subsidies were not sufficient to cover capital expenditures, requiring recourse to borrowing to cover the difference. In 1998, the share of investment which could be financed by net savings and own capital revenues declined, with an increased role for financing by targeted subsidies and borrowing.

³¹ Stefan Ivanov, "Mechanism for Government Transfer Allocation to Municipalities", Policy Forum on Fiscal Decentralization in Bulgaria, 3-4 November 1998.

³² Local governments can decide according to which law to sell their property. If the sale is based on the Municipal Property Act, the funds obtained can be recorded in the municipal budget under own (capital) revenues. If the sale is based on the Privatization Act, the funds must be booked in the off-budget Privatization Fund, and used only for investment purposes.

³³ Note that Bulgarian local government accounts are not structured to identify net savings.



Table III.12: Financing of Local Investments (on Budget)

Million BGL	1996 actual	1997 actual	1998 actual	1999 budget
(1)Capital revenues	7,546	88,213	192,521	149,015
– Net savings	3,348	34,193	50,710	31,566
– Own capital revenues	995	10,720	15,512	35,571
– Targeted subsidies	3,203	43,300	126,299	81,878
(2)Capital expenditures	9,066	79,348	212,050	211,588
as percent of total expenditures	8.2	8.0	12.8	11.4
(3)Balance to Finance (1-2)	-1,520	8,865	-19,529	-62,573
(4)Financing	2,172	3,272	22,017	46,273
– Borrowing / bonds ³⁴	2,150	3,267	22,017	106,273
– Financial transactions	22	5		-60,000
(5)Result of capital operations (3+4) ³⁵	652	12,137	2,488	-16,300
Share of investment expenditures financed:				
– By net savings	37	43	24	15
– By own capital revenues	11	14	7	17
– By targeted subsidies	35	55	60	39
– By borrowing	24	4	10	50

Source: Calculated from data of the Ministry of Finance, Stefan Ivanov

The State Budget Act limits the amount of investment that local governments may engage in, above the amounts authorized through the targeted investment grants. This limit is defined as an additional 10 percent of annual MoF-defined own revenues, and applies to the budget, not to off-budget funds. It has been reduced to 5 percent of annual MoF-defined own revenues in the 2000 budget. The spending limit is calculated in Table III.13, and is compared to actual additional investment expenditures (defined here as total investment expenditures minus the amount of targeted investment subsidies). The result shows that even with the investment limits required by MoF, local governments have not spent up to the full amount of the limit. For the planned 1999 budget, local governments budgeted investment expenditures up to the ceiling. In 1996 and 1998, local governments reached over 80 percent of the ceiling. Given that the 2000 limit has been reduced to 5 percent, this suggests that local investment will be seriously constrained for this fiscal year.

³⁴ Note that the amount of borrowing in 1999 is the amount budgeted at the beginning of the year, and the end result for local governments is not likely to be near this figure. Also, 91.7 billion of the borrowing amount for 1999 is for loans for the city of Sofia, of which about 60 billion leva is likely to be used for payments on a financial transaction.

³⁵ The result of capital operations for 1999 is covered by the deposits in local government bank accounts at the beginning of the year.

Table III.13: Permitted Level of on Budget Investments and Borrowing

Million BGL	1996 actual	1997 actual	1998 actual	1999 plan
Investment from own revenues³⁶				
Total MoF-defined own revenues	72,807	650,339	1,027,444	1,278,911
10 percent of MoF-defined own revenues	7,281	65,034	102,744	127,891
Invest. Expend.–targeted subsidies	5,863	36,048	85,751	129,710
Percent of Invest. Authority used	81	55	83	101
Deficit / Borrowing limit				
Total revenues	111,484	1,003,331	1,677,485	1,859,271
10 percent of total revenues	11,148	100,333	167,749	185,927
Borrowing	2,150	3,267	22,017	106,272
As percent of revenues	2	0	1	6
Percent of “borrowing” auth. Used	19	3	13	57

Source: Calculated from data of the Ministry of Finance, Stefan Ivanov

The Municipal Budgets Act (Article 10) defines a separate limit, on the budget deficit (10 percent of total revenues), which may be financed from borrowing (loans and bonds) and off-budget resources. De facto, this is also a borrowing limit, due to the way budget authorizations and implementation functions; in addition, any short-term liquidity borrowing must also respect the 10 percent limit (article 24 of the municipal budgets act). Table III.13 illustrates that from 1996 to 1998, municipalities have used only a small proportion of their permitted borrowing authority.³⁷

Table III.14: Total Investment Spending – On- and Off-Budget

Million BGL	1996 actual	1997 actual	1998 actual	1999 budget
Total investment expenditures	16,975	126,235	312,641	211,588
– On-budget ³⁸	9,066	79,348	212,050	211,588
– Off-budget	7,909	46,887	100,591	
AS PERCENT OF TOTAL EXPENDITURES	14.2	12.0	17.6	11.4

Source: Calculated from data of the Ministry of Finance, Stefan Ivanov

Including off-budget investment expenditures in the total of investment made by local governments shows an improved situation (Table III.14). That is, the share of

³⁶ According to Article 14(3), State Budget for the Republic of Bulgaria for 1999 Act.

³⁷ The 1999 data represent the initial budget plan, and the largest share of the amount of borrowing is for the city of Sofia.

³⁸ These figures do not account for unpaid liabilities.



investment in total expenditures increases by 4 to 6 percentage points. Many of these expenditures should be appearing on budget in 1999.

Table III.15: On- and Off-Budget Investments by Population Category - 1998

	<10,000	10-20,000	20-50,000	50-100,000	>100,000	Sofia
Per Capita Indicators (old leva)						
On-budget investment	19,530	14,843	14,024	9,129	31,184	25,844
Off-budget investment	3,171	7,095	7,265	16,289	216,436	12,263
Targeted subsidies	1,415	9,625	8,039	4,308	19,059	15,345
Averages (million old leva)						
On-budget investment	126	214	421	660	5,341	81,780
Off-budget investment	20	102	218	1,178	2,694	21,992
Targeted subsidies	91	139	242	312	3,264	47,189

Source: Calculated from data of the Ministry of Finance, Stefan Ivanov

Data on per capita investments and targeted subsidies by population category illustrates that it is an advantage to be a larger local government (Table III.15). In terms of targeted subsidies, larger local governments tend to receive more targeted subsidies per capita (except for cities of 50-100,000 inhabitants). Per capita on-budget investments are higher in the population ranges below 50,000, compared to the anomalous 50-100,000 category. Off-budget investment expenditures are of greater importance in the larger cities, and except in Sofia, exceed on-budget investments.

However, this additional information still does not detract from the conclusion above: there remains a considerable need to improve, rehabilitate and extend local government infrastructure and networks, repair essential buildings and equipment, etc. And this effort cannot be implemented without increased access to capital markets and an improved local government financial situation to repay such borrowings.

C. Municipally-Owned Companies (MOCs)

1. Overview

In many cases, basic municipal public services, such as water and sewerage, district heating, garbage collection and public transport are delivered by Municipally-Owned Companies (many of them, former municipal enterprises) that operate as commercial entities. Moreover, for the reasons discussed in Chapter II, above, there may be persuasive policy reasons to support expanded reliance on MOCs for delivering such services. In particular, workable decentralization will necessitate increasing shift of responsibility from national ministries (and their affiliated State-owned companies) to MOCs that are fully accountable to general-purpose local governments and local voter/consumers. Most relevantly, this form of service organization lends itself quite



readily to the use of revenue bond type financing for infrastructure investments. Thus any development of legislation for municipal credit markets must consider the availability of credit to such companies.

General Legal Status of MOCs. *The Commerce Act 1991* as amended provides that former municipal enterprises shall become sole proprietorship, limited liability companies or joint stock companies based upon a resolution of the municipal council concerned. (*Article 62*). Thus they became commercial companies, established and registered under that *Act*. MOCs have their own assets and property, and have the power to borrow money and perform other commercial functions. Their debt as a commercial company is separate from that of the municipality itself, even if the municipality holds 100 percent of the company ownership. Such companies may become bankrupt under *Part Four* of the *Commerce Act*, so that issues related to remedies for default on debt are clear. In addition, once a former municipal enterprise has been organized as an MOC, it may be privatized, in whole or in part, based upon the *Commerce Act* and upon the *Transformation and Privatization of State-Owned and Municipal Enterprises Act 1992*, as amended.

Despite the above legal provisions, the actual transformation of utility enterprises into municipally owned companies or private companies operating at a municipal level has proceeded slowly. Some recent legislation appears to have validated a continuing role for municipal enterprises in the pre-transition sense of the term. (See Box III.2) On the other hand, the Council of Ministers has recently encouraged municipal councils to transform municipal enterprises into MOCs as one among several recommended measures to reduce local government employment by a targeted ten per cent in the Year 2000 budget year.³⁹

³⁹ The referenced Council of Ministers recommendation flows from various measures to reduce the size and cost of municipal administration and achieve balanced municipal budgets for 2000. See, for example, Decree No. 219/1999. Art. 51 as well as macro-framework parameters for the 2000 State Budget (published in the State Gazette, issue 108, 1999).



BOX III.2: MUNICIPAL ENTERPRISES AS OPPOSED TO MOCS

Recent amendments to *Part Six (Municipal Enterprises) of the Municipal Property Act* more specifically identify municipal-owned enterprises which are specialized units of the municipality, which have no capital of their own and are not commercial companies. (*Article 52*). In effect, such municipal units/enterprises are line agencies or departments whose revenues are merged with the overall municipal budget. They may carry out such services as operation of municipal markets, operation of municipal housing, social services, operation and maintenance of municipal facilities (sports, educational, cultural), recreation, transport services, and public and communal services. (*Article 53*). Thus municipal services may be carried out by either commercial companies or by these municipal units/enterprises. (*Article 51*).

Note: Compounding the confusion, some former municipal enterprises converted to MOCs over the transition period, still retain “enterprise” in their company’s name — for example, the Sofia District Heating Enterprise.

Moreover, under pressure from international and European institutions, including the IMF, the World Bank and the EBRD, several landmark pieces of comprehensive legislation have recently been enacted which would encourage fuller decentralization and privatization. *The Waters Act 1999* and the *Energy and Energy Efficiency Act 1999* are discussed below with regard to these issues. Also, relevant provisions of the *Road Transport Act 1999* contain some similar provisions pertaining to public transport.

Financial Viability/Setting and Collection of Charges. Regardless of the exact legal form of an MOC, its creditworthiness requires a stable system of financing, based upon charges that cover all costs and upon transparent subsidies if such costs are not charged to all customers. The recently enacted set of laws just identified above (pertaining to the water, energy, and transport sectors, respectively) each provides for the pricing of services based upon actual cost, including in some instances, explicitly reference to amortization. However, at present, none of these legislated pricing policies has been fully implemented.

Finally, it is important to note that in regulating charges for basic urban services, Bulgarian Law makes a somewhat arbitrary distinction between “fees” and “prices”. For example, for various historical reasons, water and district heat charges are classified as “prices”; rates for garbage collection are designated as fees. Fees, in contrast to prices, are subject to Constitutional limitations on the local discretion to set rates. Moreover, in practice, Parliament has gone further in liberalizing “prices” for key services than it has with fees.

The remainder of this section of the report reviews relevant aspects of both the governing law and the financial status of MOCs in the water, district heating, garbage collection, and urban transport sectors as applicable to their prospects for becoming active borrowers in a private, municipal credit market.

2. Water and Sewerage

Legal Status of Water and Sewage Services. With regard to water and sewerage, district heating and public transport, the State still retains a strong role. For water and sewerage, all enterprises have now been registered as companies under the Commerce Act. However, only 20 of the 49 enterprises are 100 percent municipally owned. An additional 22 companies are mixed (State/municipal) with the State holding a controlling 51 percent share and the remaining 49 percent held by from three to as many as thirty municipalities in the region served by the utility in question. Seven companies are 100 percent State-owned (See Annex C).⁴⁰ Individual municipalities have little say in the mixed and state companies.

The World Bank Water Companies Restructuring and Modernization Project (Loan 3739) provides a loan to Bulgaria to help in the restructuring and decentralization of regional water and sewer enterprises to commercial companies, to improve their management and efficiency, and to fund certain priority water and sewerage projects.⁴¹ It was hoped that the companies might be decentralized to regional or local ownership and/or privatized at a later date. To date, this has not occurred.

The new *Waters Act 1999* (which takes effect on January 28, 2000), does not speak to decentralization, but it does define municipal property for water and water infrastructure (*Articles 18-22*), and gives specific powers to the mayor and municipal council with regard to the setting of policy and the implementation of projects for water and sewerage infrastructure that is municipal public property. [See *Article 10(2)*, *Article 41(2)*, *Article 191*.].

Financing Viability and Pricing Policy/Water and Sewer Services. The above referenced *Waters Act 1999* specifies a cost-based approach to setting prices for water and sewerage services. *Article 193(1)* states that such price shall “cover the costs for construction, operation, maintenance and reconstruction of the systems and facilities required for the delivery of relevant services”. Further, *Article 193(2)* provides that such prices shall include water use fees only for water quantities actually consumed by users. In addition, beginning three years after the enactment of the law (thus July 28, 2002), the water service fee shall not include water losses that exceed 25 percent of the total water produced by that company. (*Article 193(3)*). The *Act* does not explicitly allow for a regulated profit margin in setting the water charge--in contrast to the predecessor legislation, which permits a 20 percent add-on for profit. The *Act* also allows, for the first time in Bulgaria, the introduction of a charge for the use of raw water.⁴² (*Articles 43 and 194(2)*).

⁴⁰ Most of the municipally owned enterprises are limited liability companies. Only one (Sofia) is a joint stock company.

⁴¹ The loan is effective October 1995 with a closing date of June 2002.

⁴² The charge applies only to users who consume more than a specified minimum (0.2 liters per second or 10 cubic meters per 24 hours).



This legislation should bring significant change to the pricing structure for water. As a rule, presently water users only pay for a permit to consume water, not a fee for the amount that they actually use. This contributes to wasteful patterns of consumption often over 50 percent of the total amount supplied.⁴³ In the absence of a precise standard for setting such a charge, the municipal council often has approved a rate much lower than that recommended by the Water Company itself. One such case happened in 1999 in the run-up to local elections. Unfortunately, even the new Law does not specifically deal with such a possible violation.

In addition, the new Law does not change the present system for collecting charges. Billing and collection is done by the water and sewerage enterprise on a cash system. One has to go in person to pay the bill. Generally, the Ministry of Environment and Waters reports that the rate of compliance is only 50 percent to 55 percent, with a 70 percent compliance rate in villages. The new Law also does not provide strong new provisions for enforcement of collection, such as authorizing cut-off of water service for non-payment. In fact, the *new Law on Consumers and Rules for Trading 1999* enters the situation in a negative way. That Law sets a general principle that the prices for basic services shall not be too high. There have already been efforts by consumers to use that principle to avoid the cut-off of water supply for non-payment of charges. Thus the potential for borrowing by municipal water and sewer enterprises remains limited by their lack of stable revenues, although this situation may change when the new *Waters Act* takes full effect.

BOX III.3: CONCESSION ARRANGEMENTS AS A SUBSTITUTE FOR PUBLIC INVESTMENT AND THE USE OF MUNICIPAL CREDIT

Bulgaria has witnessed several local efforts to use concession agreements as a source of funds using the provisions of *Chapter Eight (Articles 67-75) of the Municipal Property Act*. The Sofia Water and Sewerage Company has just entered such an agreement. Such agreements typically obligate the revenues of the company or enterprise actively for a long period of time (at least 15 years). Often an underlying aim of such concession arrangements (and focus of the associated negotiations that precede them) is to obtain a commitment from the concessionaire to make needed investments (for equipment and/or infrastructure) in exchange for being granted a long term and exclusive claim on a captive revenue stream (such as water tariffs or garbage fees). As such, concession agreements represent an alternative to the use of municipal credit to fund capital projects—in effect shifting responsibility from the municipality to a private, creditworthy firm that has more ready access to financing on favorable terms.

3. District Heating

Legal Status of District Heating Companies. For district heating, all companies remain 100 percent State-owned with the exception of the Sofia District Heating

⁴³ Prior to the new Water Law taking affect, prices have been set in accordance with Ordinance/Regulation No. 9 of September 14, 1994 on the Use of Water Supply and Sewerage Systems, as amended, issued under the Waters Law 1969, as amended, which the new Act replaces.

Enterprise. That Enterprise is 100 percent municipally-owned and operates as a joint stock sole proprietorship company under the Commerce Act. It provides about 70 percent of the district heat in Bulgaria. *The Energy and Energy Efficiency Act* encourages district heating and other energy companies to restructure themselves into separate companies for production, transport and distribution, with the goal of eventual privatization. (Article 25.) The Sofia District Heating Enterprise has been slated for privatization. The other district heating companies are to be integrated into companies that are, in part, municipally owned. A portion of the recent World Bank loan (approved December 1999) will be used to restructure the Sofia Enterprise and other district heating companies.

Financing Viability and Pricing Policy/District Heating Services. *The Energy and Energy Efficiency Act 1999*, enacted on July 16, 1999, will affect the pricing and management of district heating over the next several years. At present, district heat prices for private customers are set at about 82 percent of total cost (including amortization), with the balance subsidized. Industrial customers pay a “real market” price of total cost plus a small profit.⁴⁴ Present plans call for the subsidy to private customers to be phased out by the end of 2001 by which time prices would be set according to the same standards as apply to prices for industrial users.

Article 95(3) of the *Act* directs the Council of Ministers to promulgate a new Ordinance for prices for 2002, based upon a proposal to be made by the new State Commission for Energy Regulation. The Ordinance shall specify that district heat prices take full account of “economically justified costs”, including environmental protection, maintenance of fuel reserves and the recovery of economically justified investments (including those for repair, rehabilitation, and energy saving programs).⁴⁵ (*Article 22(1).*)

On paper at least, pricing based on the new Ordinance should open the prospect of true financial viability for district heating companies and their successor distribution companies. However, in practice, payment collection may remain a problem (or could even worsen as prices ratchet up).⁴⁶ The Energy and Energy Efficiency Act provides for a system of heating agents who would act as intermediaries responsible for demand side management, including bill collection. (see Article 107.) This approach is very new

⁴⁴ See Ordinance on District Heating Price Setting and Price Application (Decree of Council of Ministers N140 of June 29, 1999, effective: July 3, 1999; S.G. 60 of July 2, 1999.

⁴⁵ Such prices may also include economically costs resulting from additional obligations imposed by State authorized bodies.

⁴⁶ The Sofia District Heating Enterprise presently collects about 86 percent overall of the payments due it, about 80 percent of those due from private customers and 95-97 percent of those for industrial customers. This represents a dramatic improvement over the 55 percent collection rate as of 1995. The uncollected amount is now covered by a State subsidy referenced in the annual Budget.



and is not yet operational. In addition, the potential for billing and collecting based on true costs should be enhanced by the new metering system now being implemented.⁴⁷

The Sofia District Heating Enterprise is on a list of 100 companies that are forbidden to borrow until the Ministry of Finance issues a financial recovery plan for bringing them to solvency. The Enterprise's management hopes that the company will be off the list by July 2000. They also are considering a plan to raise investment funds through the sale of "energy bonds" which would be payment vouchers that guarantee the availability of heat. District heat consumers (including banks) would purchase the "bonds", which would bear a standard interest rate and a term of perhaps 6-8 years. However, for such bonds to be marketable, the District Heating Enterprise would first have to demonstrate improved economic stability. At present the only source of investment funding remains international institutional investors such as the World Bank and EBRD.

4. Garbage Collection

Legal Status of Garbage Collection Companies. Garbage collection typically is performed by MOCs, which are 100 percent municipally owned. One exception is the Sofia Hygiene/Sanitation Municipal Enterprise (Tschistota-Sofia AG). In March 1999, that Company was privatized from a 100 percent municipally owned stock company to a company owned 75 percent by its 600 employees and 25 percent owned by the Sofia Municipality. This scenario followed a standard method for privatizing State-owned enterprises but this represents its first application to an MOC. In practice, the municipality remains in control.

Financing Viability and Pricing Policy/Garbage Collection Services. As noted above, unlike *prices* for water, sewerage, and district heating, *fees* for garbage collection are set pursuant to the *Local Taxes and Fees Act 1997, as amended*. The municipal council approves the local fee based upon a formula defined by *Chapter Three, Section 1 (Articles 62-71)* of the *Act*. This fee covers not only the collection, transport and treatment of garbage but also the cleaning of streets and other publicly used areas in residential locations. (*Articles 62 and 66*). Per *Article 64* of said act, the fee shall be imposed on property owners and paid at the same time as the tax on real property.⁴⁸

Article 67 then states that for residential property, including that of enterprises, the fee shall be set either proportionately on the basis of the real estate tax assessment

⁴⁷ The present World Bank District Heating Project begun in 1997 and part of the Water Companies Restructuring and Modernization Project finances installation of meters. In addition, the new World Bank loan, mentioned above, along with an associated EBRD Loan, would modernize 8000-9000 substations, including all such building substations in Sofia. At present, only about 20 percent of such buildings in the Capital have appropriate meters.

⁴⁸ Thus it is generally paid in four equal quarterly installments. (Article 69(1))



or set in Leva based upon quantity of garbage. For non-residential property, the fee shall be set in Leva depending upon the number and type of garbage containers.⁴⁹

In a number of instances, actual garbage collection is carried out under a concession arrangement. In Rousse Municipality, the concessionaire is a joint venture between the municipal garbage enterprise and a German company. In Sofia, the concessionaire is the Sofia Hygiene/Sanitation Municipal Enterprise itself. The Sofia concession was awarded for 15 years in August 1999 and began on October 1, 1999. The enterprise agreed to provide and service 1000 garbage bins and to make investments in the first 2 to 3 years in street-cleaning vehicles.

However, the Public Procurement Act 1999 in its Transitional Provisions amended Article 70 of the Municipal Property Act to eliminate garbage collection as a subject proper for municipal concessions. Such concessions are now permitted only for water supply and sewerage, for transport services and for commercial activity carried out on real property that is public municipal property. The Amendments reported purpose is to eliminate evasion of the public procurement rules with regard to the provision of most basic municipal services.

Concession agreements for garbage seem to mask subsidies for that service. In Sofia, collections account for only about 50 percent of payments made to the concessionaire. Thus the Sofia budget contains an internal subsidy for garbage and street cleaning. In addition, municipal garbage companies do not have ownership rights to municipal landfills, which must remain municipal public property. Thus improvements to landfills must come directly from the municipal budget.

Despite the question of subsidies (transparent and hidden), the long-term nature of concession agreements for garbage collection appear to offer some opportunity for credit-financing for such enterprises. The Sofia Hygiene/Sanitation Municipal Enterprise reports that it is presently negotiating with a foreign bank for a loan in the amount of US \$4 to 5 million for the purchase of new vehicles. It hopes to get terms of 3 to 5 years with an interest rate of about 11 percent per annum. By purchasing the vehicles from the lender's country, the Enterprise may be able to obtain credit insurance and thereby eliminate (or at least significantly reduce) any collateral requirements.

⁴⁹ In case the number of containers cannot be established, then the non-residential property garbage fee shall also be set proportionately based upon the real estate tax assessment.



5. Urban Public Transport

Legal Status of Urban Public Transportation Companies. As a rule, the companies that provide urban public transport within a single municipality are municipally-owned. Public transport companies that operate inter-city transport and international transport may be State-owned enterprises or private enterprises. The Sofia Municipal Transport Company is presently a holding company controlled by the municipality with five daughter enterprises responsible, respectively, for the operation of electrified services- trolleys and electrified buses, regular buses, repairs of electrified vehicles, repairs of regular buses, and for repair and construction of rails. The holding company has a number of side activities, including a travel agency for international transport.

Financing Viability and Pricing Policy/Public Transport Services. In contrast to the recent laws that govern services for water and sewage and for district heating, the new special legislation for public transport, the *Road Transport Act 1999* (enacted in September, 1999) does not specify a method for calculating transport tariffs. However, it does state in *Article 5* that such tariffs for both passengers and goods/freight shall be set freely, depending upon demand and supply. An Ordinance promulgated by the Ministry of Transport shall set the rules for such prices and the terms for transport. Carriers are obligated to announce such tariffs and terms to their customers.

At present, transport tariffs are typically subsidized for the elderly/pensioners, veterans, school children, pregnant women and other groups based upon a municipal ordinance. In Sofia, the Municipality itself pays 70 percent of the cost of such subsidized tickets for three months in advance. The remaining 30 percent of the subsidy is absorbed by the Holding Company.

The Sofia Holding Company for Public Transport has no right to borrow. If new buses are needed the Municipality purchases them. In other municipalities, only a fraction of the costs for providing public transport services (e.g., two-thirds in Rousse) are recovered by revenues. Under such circumstances, there is no financial basis on which to borrow. Efforts are being made in Rousse to set up joint ventures on certain bus routes with private companies in order to finance buses for those specific routes. However, this would probably do little to help the Public Transport Enterprise as a whole to attain true financial viability.

6. Summary

The transformation of municipal enterprises delivering public services into commercial companies provides the legal basis for such independent entities to receive their own credit rather than relying upon the municipality. However, the creditworthiness of such enterprises awaits a stable source of future revenues based on recovery of actual costs, including amortization, as well as better enforcement of



collections. *The Waters Act 1999* and the *Energy and Energy Efficiency Act 1999* provide for the possibility of charges set on actual costs in the near future but the problems of collection and enforcement will still need to be solved. In addition, as noted above, the law must establish a clearer legal basis for the pledging of the future revenues of such companies as loan security. As with landfills, much of the property associated with such utilities, including landfills and water and sewerage infrastructure, is municipal public property, which cannot be pledged as security.

IV. FINDINGS AND RECOMMENDATIONS

A. *Recommended Legal Reform Strategy*

The preceding chapters of this report have addressed key policy considerations in credit market development, and have provided an overview of the nascent market for municipal credit, present municipal creditworthiness and the status of municipally owned companies. Based on the above, as well as a review of the existing legal restrictions on municipal credit in Bulgaria, and comparative experience from other countries, we recommend a legal reform strategy for municipal credit market development consisting of two major elements:

This first set of recommendations describe a comprehensive *Law on Municipal Credit*, that aims both to encourage and to better regulate those Bulgarian municipalities (a small number at present) who have the financial ability to increase their use of debt financing.

- The second set of recommendations aims at increasing the number of local governments (one hopes, in time, virtually all municipalities) that are creditworthy borrowers and that can routinely utilize debt financing to meet a significant portion of their capital investment need.

In addition, the recommended legal reform strategy includes supplementary recommendations:

- To amend the laws that govern debt issuance by Municipally Owned Companies registered as commercial entities.
- To address several aspects of existing capital market and financial sector legislation that inhibit financial institutions from committing more of their assets to municipal loans.

As noted earlier, the reader should keep in mind that the legal reform strategy elaborated in this document must be embedded in a larger policy framework that further clarifies the roles of public and private-sector entities in the operation of a municipal credit market and the related requirements for their institutional development.

Building a Comprehensive and Consolidated Legal Framework for Municipal Credit. These recommendations propose a more consistent set of rules to govern the issuance of municipal debt and to clarify the rights and obligations of borrowers and lenders over the life of any borrowing, most importantly in the event that problems with repayment arise.

Twofold Purpose. Here the aim is twofold:

- On the one hand, to facilitate private, critical investment financing for those few municipalities that can now afford it.
- On the other hand, to guard against highly imprudent municipal borrowing and other forms of abuse that can arise if municipal credit is not properly regulated. As municipal borrowing grows, well conceived regulation is needed to protect:
 - The interests of citizens within the borrower community itself (and the related national interest in maintaining financially solvent government throughout the country).
 - Individual investors (particularly those who are relatively unsophisticated) who may directly or indirectly have his savings invested in municipal securities.

Moreover, proper regulation can help avoid the type of major loan default or official impropriety (and the attendant bad publicity) that could seriously set back orderly municipal credit market development.

The Need for a New and Comprehensive Debt Law for General Purpose Local Governments. Existing municipal and financial sector laws in Bulgaria do not comprehensively address the debt of general purpose, local governments debt. Relevant rules are largely indirect, scattered among various laws and regulations or established on an informal basis. In several important instances they are incomplete or ambiguous. Thus we strongly recommend a comprehensive and consolidated set of legal provisions to govern municipal borrowing, which could be enacted as a separate *Act on Municipal Credit*. As appropriate, this new law would amend existing legislation that impinges on municipal debt issuance such as the *Public Offerings Act*⁵⁰, the *Registered Pledges Act*, and the *Banking Act*, as well as the *Municipal Budgets Act* and the *Local Self-Government and Local Administration Act*. A comprehensive statute can provide a clarity and consistency in interpretation helpful to a new market (without established practices and customs) as it seeks to establish itself. It can establish model characteristics and issuance procedures in one place for all forms of municipal debt instruments (both loans and bonds).

As appropriate, this new law would amend existing legislation that impinges on municipal debt issuance such as the Law on Public Offerings of Securities⁵¹, the Registered Pledges Act, and the Banking Act, as well as in the Municipal Budgets Act

⁵⁰ Recently replaced the *Securities, Stock Exchanges and Investment Companies Act*.



and the Local Self-Government and Local Administration Act. However, if such a separate *Municipal Credit Act* proves politically infeasible, then steps should be taken to directly amend existing laws and regulations, and perhaps to add a new chapter to the *Municipal Budgets Act*. Whether a new Act is approved or not, legislation must address the most serious deficiencies and needs, namely:

- Establish disclosure requirements specific to municipal needs that give private lenders confidence that lending to municipalities is a manageable risk and that they can obtain the information needed for sound underwriting of municipal debt.
- Establish a debt limit, based on the level of debt service, to preclude municipalities from borrowing beyond their means, and prohibit balloon repayments of principal.
- Clarify the authorized purposes for municipal borrowing.
- Reinforce the binding nature of municipal debt obligations (on future municipal councils).
- Eliminate any implication of implied central government guarantee of municipal credit.
- Allow municipal governments, as legal entities, to perfect pledges of own source future revenues, and thus provide the legal basis for revenue bonds and State aid intercepts—and, concurrently to move away from reliance on pledges of physical collateral to secure their borrowings.
- Clarify remedies in the event of municipal insolvency and establish clear priorities among lenders and other classes of creditors.

Measures to Strengthen the Role of Municipally Owned Companies. The reform strategy should help strengthen and enlarge the role of MOCs as in most instances the preferred vehicle for organizing and delivering public utilities and other services that lend themselves to operating on a largely self-financing, business-like basis. Over time, local governments should be able to look towards funding a significant portion of essential investments through such companies. Assuming progress towards building solvent MOCs through tariff reforms and improved payment collection, in time much of this investment could be financed through revenue bonds (secured by pledges of company income) that isolate the local government from any financial obligation or direct risk. As noted in Chapter II, progress in this regard also requires resoluteness on the part of municipal mayors and councils in approving adequate tariffs and supporting aggressive collection policies.



MOCs, as companies whose operations are governed by commercial law, enjoy greater latitude in seeking and structuring investment credits than do the general purpose local governments to whom they are accountable. As a result, the scope of recommendations addressed to MOCs is narrower and briefer than those aimed at debt issuance by general purpose local governments themselves. Nonetheless, some improvements to the enabling framework for MOCs are needed both:

- To make sure that the legislative regime (particularly in respect to tax policy) does not discourage channeling municipal investment through self-financing MOCs when appropriate.
- To provide similar protections against ill-advised forms of borrowing as would be recommended in the more comprehensive law that would apply to municipal governments.

Measures to Strengthen Municipal Creditworthiness. Here the recommendations complement the arguments in favor of ongoing efforts to advance the legal framework for fiscal decentralization and for putting municipal finances on a sounder, more self-sufficient basis. Building a better legal and institutional framework for fiscal decentralization is critical to advancing a wide array of objectives aimed at achieving more effective and responsive local government in Bulgaria. From the narrower perspective of municipal credit market development, clearly progress on this front is a pre-requisite for private lending to emerge as a major, if not the predominant, means for financing local investment needs. The recommended reforms would:

- Strengthen municipal authority and capacity to increase revenues and control operating expenditures, with an eye to generating a meaningful level of annual net savings in the operating budgets on a predictable and recurring basis. As emphasized throughout this report, such savings are the key prerequisite for local governments to be able to service debt obligations and rely on private capital to finance critical infrastructure and facility needs. Here acting on the Prime Minister's call for a constitutional amendment that would allow municipalities to set tax and rates unilaterally would provide an important impetus for progress in this direction.
- Motivate and reward those municipalities that take the initiative to borrow and invest, particularly for capital improvements that pay for themselves through savings in operating costs.



- Improve the capacity of local governments to manage their finances in a more effective and accountable manner regardless of their financial condition. Here, when viewed from the prism of credit market reform, the chief aims are:
 - (1) To simplify due diligence for lenders. Financial institutions will be more inclined to take the trouble to underwrite municipal credits if they have ready access to reliable information on municipal financial condition—particularly in respect to actual debt service capacity.
 - (2) To give suppliers of credit confidence in the financial procedures, systems, and management capacity of local government in respect to:
 - Their ability to properly account for funds
 - Their ability to financially manage investment projects
 - Their ability to reliably forecast budget revenues and expenditures and manage budget execution
 - Their ability to administer local taxes and collect local fees, especially if pledges of these revenue sources are to become accepted as the preferred security for municipal lending

B. Elements of a Comprehensive Law on Municipal Credit

This section addresses in turn each of the recommended elements for inclusion in a comprehensive law on municipal credit under the following headings:

1. Municipal Authority to Borrow
2. Purpose of Borrowing
3. Restrictions on the Issuance of Municipal Debt
4. Characteristics of Municipal Debt (Terms, Tax Status; Security/Guarantees)
5. Disclosure
6. Prudential Investment of Proceeds
7. Purchase and Resale of Bonds
8. Lender Remedies in Event of Default
9. Central Government Approval, Monitoring and Intervention

The above elements can be found in laws regarding municipal credit throughout the world. They have been chosen based upon comparative, international experience in terms both of positive results from well-conceived enabling legislation and of lessons learned from problems encountered which might have been avoided by more careful attention to the legal framework at the outset of credit market development.



NOTE: The recommended law would set forth consistent requirements for both direct loans from banks and other financial institutions to municipalities and for the issuance of municipal bonds for sale to institutional and individual investors. As appropriate, additional provisions specific to municipal bonds would be included.

1. Municipal Authority to Borrow

Present Law/Practice. The present legal framework sets forth a clear, simple, and reasonable procedure for authorizing municipal debt at the local level. Municipalities in Bulgaria have the general power to borrow under *Article 40(1)* of the *Municipal Budgets Act 1998*. In addition, *Article 52(4)* of the *Local Self-Government and Local Administration Act 1991*, as amended, gives each municipality the right to issue bonds. *Article 21(10)* of this Act delegates decision-making authority in respect to bank loans and the issuance of municipal bonds to the municipal council.⁵² The *Municipal Budgets Act* similarly affirms that a resolution of the municipal council provides sufficient authorization to effect lawful transactions with banks and other financial institutions. (*Article 40(1)*). No other action or approval is required.

However, there are two ancillary issues in respect to municipal debt authorization that the proposed legislation might address.

Firstly, *present law prohibits a municipal council, within six months before the expiration of its term of office, from passing a resolution to contract a bank loan, issue a municipal bond or extend short-term interest-free loans from the municipal budget. (Municipal Budgets Act, Article 40(4)).* Here the intent is to prevent the issuance of debt for politically popular projects that may have the effect of influencing the electorate, but more importantly, to prevent the current legislative body from encumbering the municipality with excessive debt that will be binding on the succeeding municipal council. In the near term, given the limited volume of municipal borrowing activity, this mandated six-month moratorium has little practical consequence. However, as the municipal credit market develops and grows, it could prove disruptive to the "flow of deals" and secondary market supply. Also, this timing limitation could unnecessarily preclude a local government obtaining access to commercial financing during a window of advantageous market rates.

Secondly, *longer term municipal lending is inhibited by the capital market concern as to whether subsequent municipal administrations will honor debt*

⁵² Municipalities may also receive loans from the State Budget and from other municipalities. *Article 38 of the Municipal Budgets Act* permits short-term interest-loans from the State Budget to be extended to municipalities in exceptional cases, based upon a procedure and within time limits set by the Minister of Finance. *Article 41* of that Act permits municipalities, based upon municipal council resolutions, to conclude contracts between themselves for the extension and use of loans under terms established by that Act. This provision is consistent with *Article 137* of the *1991 Constitution*, which states that municipalities shall be free to associate in the solution of common matters, based on conditions set by law.



commitments made by their predecessors. Interviews conducted for this study reveal a reluctance on the part of some lenders to consider approving a municipal loan for a maturity that extends beyond the term of the present municipal council. This reluctance largely reflects uncertainty as to the political commitment of a succeeding legislative body to honor financial obligations incurred by its predecessor. Some lenders appear to believe that there is actually a legal prohibition against municipal loans that extend beyond the present council's tenure, but the problem appears to be one of market perception rather than law.

BOX IV.1: THE PHILIPPINES: HOW FEAR OF POLITICAL RISKS CAN INHIBIT MUNICIPAL CREDIT MARKETS

In the Philippine city of Cebu, a newly elected mayor made statements that questioned whether his administration would be bound to honor a debt incurred by the prior council. Ultimately, he withdrew the statements and the City paid the debt on time. However, this incident scared the financial community, and, in effect, has caused lenders to limit loan and bond maturities for local governments in the Philippines to the current administration's term of office. In order to counter this maturity limitation, some Philippine local government administrations have held voluntary referenda of the voters to demonstrate popular support for specific project debt financing and thereby overcome financial institution fears of the political risks associated with long-term lending.

Recommendations

Capital market confidence in the binding nature of a financial obligation on succeeding legislative bodies is an essential precondition for enlarging the availability of long term debt financing for municipal investment. This principle should be explicitly affirmed in any municipal credit legislation. The law itself should recite the binding nature of municipal obligation to repay debt that has been duly authorized.

BOX IV.2: EXAMPLE OF LANGUAGE ON THE BINDING NATURE OF FINANCIAL OBLIGATIONS**France, Code Général des Collectivités Territoriales**

Article L.1612-15 –The only obligatory expenditures of local authorities are expenditures necessary to pay debts that come due, and expenditures, which have been expressly determined by law.

Romania, Local Public Finance Law, 1998

Article 48. - (1) Local and judet councils, and the General Council of the Municipality of Bucharest, respectively, can approve the contracting of internal or external loans, for a long or a medium term, for public investments of local interest, as well as for re-financing the public debt, under the provisions of this chapter.

(2) Local and judet Councils, and the General Council of the Municipality of Bucharest may decide upon contracting loans by the vote of at least two thirds of their members.

(3) The local public debt incurred under the provisions of paragraph (1) represents a general obligation which needs to be reimbursed, according to the agreements concluded, from the sources available to the territorial administrative unit, with the exception of special purpose transfers from the state budget.

Additionally, as noted above there may be many cases in which a six-month delay in financing will be disadvantageous to both project costs and market opportunities. Consideration should be given to allowing the authorization of municipal debt within six months of an election—but only if a voter referendum confirms independent popular support for the municipal council's decision to approve the given financing.

2. Purpose of Borrowing

Present Law/Practice. While present law does not provide a clear, consolidated statement on the authorized purposes of municipal borrowing, it does contain several provisions that serve to define the scope of a municipality's authority to incur debt:

- **No Borrowing to Meet General Expenses.** *Article 52(5) of the Local Self-Government and Local Administration Act* prohibits a municipality from contracting a credit to defray general expenses, including wages and salaries.
- **Financing of Authorized Budget Deficit.** *Article 10(1) of the Municipal Budgets Act* permits a municipality to plan an annual budget deficit up to 10 percent of total projected revenues. Based upon a municipal council resolution, that authorized budget deficit may be financed through issuance of

securities (i.e., municipal bond issues),⁵³ loans from financial institutions, and from off-budget revenues and other sources. (Article 10, Sections (2) and (3)).

- **Financing of Temporary Deficiencies.** *Article 24 of the Municipal Budgets Act* permits a municipality to borrow from banks and other financial institutions, as well as from other municipalities, the State Budget (as set by the Minister of Finance), and from certain municipal off-budget resources and funds, in order to meet temporary deficiencies within a given budget year. Such borrowing shall not exceed 10 percent of total municipal revenues (as set under Article 6 of the Act), and must be paid back not later than the end of that fiscal year. This provision seems in conflict with the prohibition of borrowing for general expenses in Article 52(5) of the Local Self-Government and Local Administration Act mentioned above.
- **Financing of Municipal Investments.** The permanent laws that govern municipal budgets and finance contain no explicit reference to borrowing for the purpose of long-term investment in facilities and infrastructure. To find any explicit authorization of local debt for investment purposes, one must turn to the succession of annual State Budget Acts which provide that expenditures might be made from municipal budgets for the “acquisition of long term assets” from own source revenues and bank credits.” This annual authorization is subject to fairly strict limits, which are discussed in the next section of our recommendations under the heading “Restrictions on the Issuance of Municipal Debt”.

Recommendations

- (i). *Provide that temporary financing, which shall be paid within the budget year, may be used to finance cash flow budget deficits, and that financing which extends beyond the current budget year may be issued solely for investment or refinancing of debt issued for investment that serves a "public purpose" authorized in the municipal budget.*

Rationale for the Above Recommendation: As noted, present law contains no guidance or limit on the specific uses of long term debt that are viewed as valid. In particular, the law should distinguish between debt, which is issued for a "public" purpose and that which is issued for a publicly-owned, but inherently, private entrepreneurial activity. A number of Bulgarian municipalities remain engaged in the ownership and operation of varied private entrepreneurial businesses (e.g., bakeries; hotels), at least indirectly through MOCs. Perhaps the municipal credit law, in defining

⁵³ Issuance of bonds must conform with procedures set forth under the *Securities, Stock Exchanges and Investment Companies Act 1995*, as amended (recently replaced by the *Law on Public Offerings of Securities (January 2000)*).

"public purpose", should clearly preclude debt incurred for the benefit of such private entrepreneurial activities, or municipal guarantee of such debt. In other words, the municipal government could borrow on behalf of a municipally owned garbage company, but not to benefit a municipal bakery. An MOC (such as a bakery) that competes more directly with private firms should have to finance loans for its investments solely from the pledge of its own revenues and assets—not from the municipal treasury. The public purpose clause in the municipal debt law should contain an explicit prohibition against the use of the municipal borrowing authority solely or primarily to benefit a private party (property owner and or business).

(ii). Provide that the proceeds of a borrowing may only be spent on the investment for which the debt has been authorized, unless there is the approval of both the municipal council and the debt holders concerned.

One of the primary functions of the national Audit Office with regard to debt compliance is to confirm that the proceeds of a borrowing have in fact been used for the purpose authorized by the municipal council. While this does not appear to have been a problem area to date, the present listing of investments in the budget and the financing of the deficit may lead to confusion as to which investments are being financed by which borrowing. An investor or lender may welcome explicit language in the municipal credit law mandating that the proceeds of a particular borrowing are only to be spent on a specified project.

A Caveat: On balance, this restriction is desirable. However, under some circumstances, such a constraint could prove awkward if approval for redefining the targeted investment financed is not readily obtainable. For example, in Poland, a similar statutory provision limits the use of proceeds to the authorized purpose. Problems have arisen there in several instances when, subsequent to the issuance of the debt, the authorized purpose has lost its viability. For example, funds have been earmarked to repair a building that is subsequently destroyed by fire, or a Ministry of Education ruling eliminates the need for a new school after a loan has been obtained to finance its construction. In these cases, the municipality had received the loan proceeds but was not able to spend them. Since the loan terms precluded early prepayment, the municipal borrowers were forced to absorb the cost of negative arbitrage. The statutory language recommended above would hope to avoid this type of situation by permitting a change of purpose upon a resolution of the municipal council and with the consent of a lender or a percentage of the bondholders.



3. Restrictions on the Issuance of Municipal Debt

Present Law/Practice. Central governments have a legitimate concern that municipal governments don't take on an excessive amount of debt in relation to their financial resources. Most countries try to accomplish this, in part, through some form of debt limit—typically in the form of:

- A limit on the aggregate amount of indebtedness a given municipality can incur.
- A limit on the amount of annual debt service (interest and principal repayment) it can assume relative to some measure of available revenues to service this debt.

Current Bulgarian law does not contain an explicit limit on municipal debt as defined above. However, it does contain two other limits that in the minds of market participants are sometimes confused with a debt limit:

- As noted in the previous section, the *Municipal Budgets Act* permits an authorized deficit of up to 10 percent of planned revenues (*Article 10 (1)*) which may be financed by issues of bonds, loans and off-budget resources. (*Article 10 (2)*). However, this is *not* a debt limit, but rather a permitted means of financing a limited deficit.
- The annual State Budget Acts each restricts the funding of municipal investments to a set percentage of own source revenues. Thus *Article 14 (3)* of both the 1998 and 1999 *State Budget Acts* provides that expenditures might be made from municipal budgets for the “acquisition of long term assets” from own source revenues and bank credits only up to 10 percent of its annual own source revenues. Municipal bond issues were not specifically mentioned as a possible source. *Article 14 (4)* then states that if that limit is exceeded, then the subsidy from the State budget to that municipality shall be reduced by the excess amount. The *2000 State Budget Act (Article 12 (2))* reduces the 10 percent ceiling on local investment to five percent of own source revenues, a severe limitation on local discretion to finance infrastructure and other capital needs. The structure of the recent Sofia Eurobond caused the meaning of this limitation to be clarified by an interpretation of the national Audit Office. Based upon that opinion, the size of the bond issue did not violate the 10 percent deficit limitation. However, to comply with the State Budget Act limitation on investment expenditures, Sofia's use of the proceeds to fund specific capital projects had to be spread over several budget years.

Recommendations

We recommend both:

- That the proposed Law on Municipal Credit include a debt service limitation provision.
- That the Government terminates the practice of including an investment limit in the annual State Budget Acts.

Both these recommendations are detailed and elaborated below, including preferable alternatives for achieving the objectives underlying the current investment limit.

Debt Limit Recommendation. As noted above, a debt limit provision is recommended both as a means to preclude irresponsible borrowing and to constrain aggregate municipal indebtedness.

In respect to the second of these concerns, the debt of the Bulgarian public sector (defined as sovereign debt and sub-sovereign debt) has been declining as a ratio of GDP IMF Article IV Consultation With Bulgaria-2/19/99- projected a ratio of 81.1 percent for 1998 as compared to 104.1 percent for 1997- published in IMF Public Information Notice (PIN) No. 99/20 of March 10, 1999). Nonetheless, the debt ratio remains higher than the 60 percent limit established by the European Union for public sector debt. For this reason and for general reasons of prudent borrowing for municipalities which are severely restricted in their ability to generate their own source revenues, debt limitations may give comfort to both the central government and the lending community. Thus the following limitations are recommended for consideration:

a. Short-Term Debt

Short-term debt shall be issued only for the purpose of the temporary financing of a cash flow deficit in an amount not to exceed (5 percent, perhaps as high as 10 percent) of total budgetary revenues, provided that such debt is repaid within the current budget year. Romania now has such a limitation of 5 percent of such revenues. (See box below).



BOX IV.3: EXAMPLES OF LANGUAGE ON SHORT-TERM DEBT

Republic of Latvia, Law on Municipal Budgets, 1995

Article 23 – For the purpose of the budget and finance management in order to cover a short-term fiscal deficit, the municipalities shall be entitled to take short-term loans. The municipalities shall repay borrowings from the state budget by the end of the current economic year.

Article 24 – For the purpose of economic and social program implementation, the municipalities are entitled to take long-term loans. Such borrowed funds must not be used for the financing of permanent (current) functions of the municipalities.

Hungary, Act on Local Government, 1990

Article 88(7) – For the purposes of this Section, liquid credit is the credit raised and repaid within one year, for the purpose of the continuous operation of public service and state administration duties.

Romania, Local Public Finance Law, 1998

Article 53. - (1) In case during the execution temporary cash deficits are registered, as a result of the gap between the revenues and the expenditures of the local budget, the former can be covered through loans granted from the available funds in the general account of the state treasury, provided the revolving fund has been used.

(2) The total amount of the loan which can be engaged by local public authorities according to the provisions under paragraph (1) is subject to the following limits:

1) It shall not represent more than 5 percent of the total revenues which the territorial administrative unit estimates to collect during the fiscal year in which the loan is engaged;

2) According to the provisions under paragraph (2), point 1), local public authorities cannot engage loans which are larger than the funds which it can reimburse during the same fiscal year.

BOX IV.4: REPUBLIC OF LITHUANIA, DECREE ON USAGE OF BANK CREDITS BY LOCAL AUTHORITIES, 1998

Article 2 - The following limits on borrowing by municipalities are set:

2.2 The annual borrowing limit of a municipality is 10 percent, including a short-term borrowing annual limit of 5 percent, of the approved revenues of that year (excluding grants for special purposes to the municipality from the State Budget of the Republic of Lithuania).

Article 3 – Total debt of a municipality includes short-term (up to 1 year) and long-term (1 year and more) debts of all sources of borrowing.

Article 13 – Municipalities can take long-term loans for the financing of investment projects only. Municipalities can take short-term loans in the course of the year for the purpose of covering a temporal shortage of funds.

b. Long-Term Debt

Long-term debt shall be issued solely for the purpose of financing long-term investments (and the refinancing thereof) with a maturity not to exceed the useful life of the facilities being financed; provided that, the annual debt service on all of a municipality's outstanding debt shall not exceed 15 percent; of its annual "total current revenues". Total current revenues should be defined as in Box III.1, above, and should carefully exclude any one time (non-recurring) influxes of monies such as proceeds from major privatization sales. Compliance with the limitation shall be determined at the time of issuance of the debt. In order to make such calculation:

- (i) Any debt bearing interest at a variable rate shall be calculated at the maximum permitted interest rate. (NOTE: This may result in municipalities being required to negotiate a "maximum interest rate" with their lenders).
- (ii) The debt service shall be structured so that annual payments are not less than the amount that would be provided if the payments were calculated to be level annual amounts over the term of the credit, thus preventing balloon payments, uncontrolled negative amortization, or other dangerous deferrals of principal repayment. In addition, the Act would not restrict the making of prepayments or other acceleration of principal payments.

The portion of any debt service that is secured solely by a dedicated revenue source and is not payable from the general treasury of the municipality, i.e., a revenue bond, shall be deducted from the aggregate debt service calculation.



- (iii) A certain percentage (perhaps 75 percent) of the amount of any municipal guarantees made to third-party borrowers (such as municipally owned-companies) should be counted against the debt limit. However, once the municipality makes payment based on the guarantee, then 100 percent of that guaranteed debt should be included in such calculation. It is recommended that such debt be so counted for at least three years after a guarantee payment is made. It should be noted that the Polish *Act on Public Finances of 1998, Article 113*, (discussed above), appears to count 100 percent of such guarantees. The debt limitation might initially be set as low as 10 percent of current revenues, but should be reconsidered periodically as progress is made in law and practice in strengthening local government finances. Over a period of time, the debt limit might be raised to as high as 20 percent.

A debt limit, which restricts debt service to a percentage of budgeted revenues, has been used in other transitional economies (see Table IV.1). Examples of such limits presently in effect include:

Poland: annual debt service shall not exceed 15 percent of budgeted revenues, and debt carried beyond the current year may not be greater than 60 percent of budgeted revenues (*Law on Public Finances 1998, Articles 113 and 114*).

Romania: annual debt service shall not exceed 20 percent of total current revenues, including the shared wage tax (*Law on Local Public Finance 1998, Article 51*).

Further, it is recommended that the MoF be given the discretion to review and approve a municipality's request to exceed the debt limit provided that it can demonstrate that its own local revenue base can readily support a higher amount of borrowing. This exception would prove of particular importance if the Law sets the initial limit at a low level that would unnecessarily constrain Sofia and the handful of other cities that are relatively more creditworthy. This procedure would also allow flexibility to finance investments that promise a positive net impact on municipal cash flow. For example, a local government might propose a major investment in energy conservation technologies which promises to more than pay for itself in energy cost savings, but would take it above the debt limit temporarily until the reduced operating expenses are realized from the investment. (If, contrary to the recommendation of this report), the present investment limit is retained, a similar procedure for exceptions to that limit should be adopted.

Alternatives to the Present Investment Limit.

Based on comparative international experience, investment limits send an inappropriate message to local governments and are a clumsy means for dealing with



legitimate MoF concerns about municipal budgeting practices. Municipalities that generate a surplus from their operating budgets, should be encouraged, rather than prevented from using funds for municipal capital investments. In our interviews, we heard three types of arguments made to explain the necessity of preserving these limits. These arguments, and the recommended alternative for addressing the underlying concern, are as follows:

Argument #1. Many Bulgarian municipal governments are not budgeting adequately to operate essential services such as schools and medical clinics. Under these circumstances, local governments shouldn't be diverting funds to lower priority (and in some instances, relatively trivial) investments.

Response. If the concern is inappropriate municipal priorities, then the Local Self-Government and Local Administration Act in Chapter Two should be amended to specifically establish the priorities and obligatory mandates the government deems essential. This would put municipal governments on notice that these priority public service responsibilities must be met before funding other operations and investments. It should be noted that the annual State Budget Acts do set municipal budget priorities for the given year. (See Articles 14(2) and 13(3) of the 1999 State Budget Act and Articles 12(1) and 11(3) of the proposed 2000 Budget Act.) However, embodying the fundamental priorities in permanent legislation would add to the force and clarity of these imperatives.

Argument # 2. The Investment Limit is needed to head off excessive municipal deficits and indebtedness that can threaten central government efforts to preserve macro-economic stability, comply with IMF conditions, and continue progress in deficit reduction towards EU norms.

Response. If the concern is municipal deficits, this is more forthrightly addressed by a hard budget constraint that prohibits carrying forward unpaid operating liabilities into the next budget year, or makes such liabilities the first priority, municipal payment obligation in the subsequent year.

If the concern is excessive municipal indebtedness, the appropriate regulation is the type of debt service limitation proposed above, rather than an investment limit.



Table IV.1: Municipal Debt Limitations in Selected Countries

Country	Debt Service Ratio Limit	Debt "Revenue" Limit	Other Restrictions
A. Central and Eastern Europe			
Poland	15 percent of total revenue (debt service includes potential liability under guarantee commitments).	None.	<ul style="list-style-type: none"> • Short-term loans must be repaid within fiscal year; • No State guarantee, unless explicitly stated; • Long-term credit only for investment. • Carry-forward of unpaid principal on all debt to next budget year cannot exceed 60 percent of budgeted revenues
Hungary	70 percent of own current revenues (local taxes, fees, interest revenues, environmental fines). Debt service includes potential liability under guarantee commitments.	None.	<ul style="list-style-type: none"> • Local governments with outstanding loans and expenses of more than 100 million HUF must have external independent audits; • Loans cannot be secured with primary assets, general transfers from the state, shared personal income tax; • Debt-service restriction does not apply to short-term liquidity loans.
Romania	20 percent of current revenues	None.	<ul style="list-style-type: none"> • No State guarantee; debt registration documents must include a clause to this effect; • Debt incurred must be reported in the public debt register and reported annually; • Short-term cash balance loans limited to 5 percent of total revenues; • External borrowing must be approved by a Loan authorization commission
Lithuania	10 percent of total revenue, excluding earmarked grants.	Borrowing cannot exceed 10 percent of total "revenue" in approved budget (excluding earmarked grants); there is a sub-limit of 5 percent for short-term borrowing.	<ul style="list-style-type: none"> • Debt stock is limited to 20 percent (30 percent for Vilnius) of total revenue; • Short-term loans must be repaid within fiscal year; • No State guarantees; • Ministry of Finance can impose lower borrowing ceiling for individual municipalities based on budget performance; • Long-term credit can be used only for investment and must be approved by a Loan Commission of the MoF.
B. Other regions of the world			
Brazil	Debt service cannot exceed 15 percent of	Borrowing cannot exceed 27 percent	<ul style="list-style-type: none"> • State governments cannot borrow from their own State bank;



Country	Debt Service Ratio Limit	Debt "Revenue" Limit	Other Restrictions
	total revenue or operating surplus for previous year, whichever is less.	of total "revenue" in approved budget.	<ul style="list-style-type: none"> No new bond issues until 2000 except for refinancing; Long-term credit only for investment; Restrictions on foreign-currency debt.
India	None.	None.	<ul style="list-style-type: none"> No borrowing in foreign currency; Long-term credit only for investment; Need case-by-case approval of State government for municipal loans or bonds.
Columbia	Debt service limit is 30 percent of <u>recurring</u> revenue as long as debt service is also less than 40 percent of operating surplus. When debt service exceeds 40 percent of operating surplus, municipalities are subject to a variety of fiscal controls.	None.	<ul style="list-style-type: none"> Temporary imposition of 1.5 risk weighting on municipal loans for capital adequacy calculation; Collateral requirement can be up to 150 percent of loan value; A limit is placed on the <u>stock</u> of outstanding debt relative to recurring revenue.

4. Characteristics of Debt

a. Terms of Debt

Present Law/Practice. As mentioned above, municipal councils are authorized by law to approve borrowing. However, the legal framework provides virtually no rules on the permissible terms (maturity of limitation, interest rate, method of restructuring debt repayment) of any given borrowing that a municipal council may decide to authorize. Other than the requirement of Article 24(3) of the Municipal Budgets Act that temporary financing be repaid within the current budget year, Bulgarian law contains no restrictions on:

- (i) The length of maturity for long-term debt. However, as discussed above, the unwillingness of the lending community to extend a maturity beyond the term of office of the existing municipal government has established a de facto maturity limitation, at least for bank lending.
- (ii) The method of interest rate calculation, i.e., variable rate or fixed rate.
- (iii) The method of structuring debt repayment, i.e., level principal payments, level debt service payments, or level interest payments.



As noted in Subsection 2, Approval to Borrow above, under the new Foreign Exchange Act it appears that debt denominated in a foreign currency would need to be registered at the Bulgarian National Bank.

Recommendation

There should be legal authority providing that:

- (i) Short-term debt for cash-flow deficit financing be repaid within the current budget year.
- (ii) Long-term debt shall have a maturity not longer than the useful life of the assets acquired with the proceeds of the borrowing. (this provision would be especially important with regard to the issuance of revenue bonds.).
- (iii) Debt may bear interest at either a fixed or variable rate; provided, however, that any variable rate shall establish a maximum limit (note: this maximum limit may create a resistance barrier for lenders and may not be practicable at the beginning or result in the establishment of very high maximum limits. Although it is a prudent idea, it may be counterproductive if it will prevent lending altogether).
- (iv) Debt may be denominated in a foreign currency only with the prior approval of the ministry of finance (or other central government authority). As a rule, municipalities should be discouraged from assuming foreign currency risk. Sofia's 1994 (dollar denominated) loan to fund buses purchases illustrates the dangers involved. At one point the city witnessed the exchange rate rise to over 3000 BGL to the dollar from a starting point below thirty.

b. Tax Status

Present Law/Practice. Tax laws have a powerful effect on the development of municipal credit markets and motivation for different categories of lenders and investors to participate in such markets.

In Bulgaria, *Article 12(1)(3) of the Taxation of the Income of Natural Persons Act 1997*, effective January 1, 1998, as amended, provides that interest paid on State securities is not liable to tax when such securities are acquired by natural persons.⁵⁴ Although this law does not explicitly reference municipal securities, in practice tax authorities have interpreted this provision as applying for interest paid on municipal securities as well.

⁵⁴ Additional Provisions #11 of the Act defines "interest" as "income from any debt claim, regardless of whether it has been secured through a mortgage or by a clause envisaging a stake in the debtor's profit, as well as income from bonds, debentures and other financial instruments related to these securities."

By contrast, the Corporate Income Tax (which applies to any interest income earned by “legal entities” does not contain any such tax exemption.

In thinking about the tax status of municipal debt, some distinctions in the overall tax status of different classes of capital market participants is worth keeping in mind:

- The tax status of pension funds will be governed by two recent laws which both took effect on January 1, 2000: *The Obligatory Social Insurance Code* and the *Additional Voluntary Pension Insurance Act*. Under the first of these laws [Article 160 (1) and (2)] the incomes of universal and professional pension funds are exempt from the *Corporate Income Taxation Act* and incomes earned on the assets in the accounts of secured persons are exempt from the *Taxation of the Income of Natural Persons Act*. The second law [Articles 2 (3) and 11(1)] contains parallel provisions for the voluntary pension funds.
- Commercial banks and insurance companies would pay taxes on interest income earned on municipal securities on the same basis as would any other legal entity.
- Licensed investment companies are exempt from corporate income tax on the profits earned from trading in long-term securities, an exemption that encourages the overall growth of a secondary market in securities.

Recommendation

Most economists argue against tax exemptions for any form of public securities on the grounds that such exemptions distort the efficient market allocation of capital among sectors and between the public and private sectors. That said, such tax exemptions are common to many countries in both the developed and transitional worlds. The important point for a municipal credit market is that as long as interest on government securities remains exempt, then municipal borrowing should be exempt as well.

We recommend that the current exemption be preserved at least for the period during which the municipal credit market is being established, given (i) that the tax exemption is already in place; (ii) that the small amount of municipal debt likely to be issued over the near term does not threaten the State Treasury with any material loss of income tax revenue from the exemption; and (iii) the possible attraction of this feature to potential investors, particularly the pension funds. The municipal credit law should reconfirm and make this tax exemption more explicitly to eliminate any uncertainty in the eyes of prospective municipal bond purchasers.



Arguments for and against continuing the municipal bond tax exemption should be reviewed if and when the volume of municipal lending becomes significant. Such a review should reconsider tax exemption with regard to all government securities, not just municipal securities, so that municipal securities are not given second-class treatment.

Similarly, if in the future the Government should decide to grant legal entities a tax exemption on income from State securities (similar to the exemption now enjoyed by Natural Persons), then this enlargement of the tax exemption should explicitly include municipal utilities as well.

(NOTE: See Section IV.C below for recommendations on the tax treatment of debt insured by MOCs.)

c. Security/Guarantees

Present Law/Practice. Current Bulgarian law and practice in respect to securing municipal debt poses several problems for the development of a municipal credit market:

- **Firstly**, unlike private sector borrowers, municipalities and their lenders have no legally authorized procedure for perfecting pledges.
- **Secondly**, there is excessive reliance on physical collateral to secure municipal debt.
- **Thirdly**, there is no clear legal authority to pledge future municipal revenue streams to secure a loan or for intercepts of central government transfers—in lieu of or in addition to pledges of physical collateral.



Registering Municipal Pledges. The *Special Pledges Act*, as amended (*Article 3*), does not authorize a municipality to register a pledge on behalf of its creditors except in very limited circumstances, e.g., the pledge of "paperless" securities. Since municipalities are not merchants under the *Act* (see *Article 3*), their pledges may not be recorded in the pledge's record at the Central Pledges Registry or other designated registry under that *Act*. Such registration allows the creditor to "perfect" his lien rights relative to those of third parties. (*Article 12* of that *Act*). This omission poses two difficulties for lenders contemplating loans to municipalities:

- Most fundamentally, the lack of a procedure for registering pledges (regardless of the form of security involved) adds to the lenders perception of uncertainty and risk should he ever have to rely on enforcement of the pledge to ensure repayment.
- Furthermore, access to the established registry for pledges would reduce the chance that a municipality might pledge the same security to two different lenders—a problem that has arisen in other countries. Pledge registration greatly simplifies the due diligence a prudent lender must undertake to guard against this risk.

The Form of Security. In Chapter II (Key Policy Considerations, above) we discussed the reasons why pledges of future revenue (as opposed to pledges of municipal property) should be viewed as the preferred means to secure municipal debt. The Municipal Budgets Act requires that loans to municipalities be "secured by a mortgage and/or pledge of municipal property", and prohibits the payment of municipal debts out of resources allocated from the State budget. (*Article 40*, sections (2) and (3)). (Note: This provision does not explicitly apply to municipal bonds.)

Further, the *Municipal Property Act 1996*, as amended, makes a useful distinction between "municipal public property" and "municipal private property". (*Article 3(1)*).⁵⁵ Only municipal private property can be used to secure debt. Public municipal property may not be encumbered for the benefit of creditors under *Article 7(3)* of that Act. *Article 7(3)* of that Act specifically permits municipal private property to be so encumbered. However, it is possible for municipal public property that has ceased to have its public uses under *Article 3* to be declared municipal private property by a two-thirds vote of all of the members of the municipal council. (*Article 6*).

⁵⁵ *Article 3(2)* of the *Municipal Property Act 1996*, as amended, defines municipal public property as (1) real property assigned for the performance of functions of local government authorities and local administration, and (2) real property assigned for the longer-term meeting of public needs of municipal significance. All other municipal property, including the products and revenues of public municipal property, is municipal private property under *Article 3(3)* of that Act.



This distinction in Bulgarian law between municipal public and private property makes good sense and should help avoid problems that Poland and other countries have encountered as their credit markets have begun to grow. These problems include both:

- The difficulty of valuing an asset committed to a long term and essential public use.
- More critically, the legal, political, and equity issues that arise should a lender actually try to foreclose on such an asset.

Given the present legal constraints, virtually all of the commercial bank loans to date have been general obligations of the municipality secured by mortgages on the municipality's private property or pledges of shares in municipally owned companies. (See Table III.1, above). To date, the actual experience in structuring real estate collateral for municipal loans has been quite limited. The problems encountered have been attributable more to particular factual circumstances than to defects in the legal framework—for example, outstanding restitution claims or confusion in the allocation of ownership interests between the national and local agencies involved.

Ambiguities in Respect to Pledges of Future Revenues. At present, Bulgarian law contains ambiguities as to whether or not a general purpose local government could make a pledge of specific, future revenue source to secure either a loan or a “revenue bond. Although the *Municipal Budgets Act* does not explicitly prohibit the repayment of such debt from municipality own source revenues, it does not contain any explicit authorization. At a minimum, the law’s silence could raise uncertainty in a lender’s mind.

Moreover, *Article 7(2)* of the same *Act* states that municipal revenues, with the exception of ad hoc grants and subventions allocated from the State budget, are to be used to cover all expenditures. This suggests that revenues from a specific tax or fee may not be set aside in a special account or fund to secure a loan repayment. Also, the only reference to “bonds” in the *Municipal Budgets Act* is in *Article 10* as a means to fund authorized budget deficits. This could suggest that the only authorized purpose of bond financing is to finance such deficits, and that such bonds must be general obligation (as opposed to revenue) bonds. Given these legal ambiguities, new legislation is needed to clearly permit the issuance of revenue bonds (As discussed below, this is not the case in respect to revenue bonds issued by MOCs, or bank lending secured by an MOC revenue pledge.)

Despite these legal uncertainties, it should be noted that there have been some recent municipal borrowings based on unsecured general obligations of municipal

revenues and/or assets—the Gabrovo loan from DSK, and the Sofia Eurobond issue and the Svishtov bond issues.⁵⁶

State Transfer Intercepts. Chapter II also recommended the concept of a State transfer intercept (if properly designed) as an attractive means to secure and enhance local credit without any State guarantee. At present, the Municipal Budget Act explicitly disallows debt repayment from resources allocated from the State budget. Clearly, specific legislation would be required to introduce the use of a broadly defined, State transfer intercept in Bulgaria.

The Question of Implied Guarantees. Present Bulgarian law does not contain any specific implication of a central government guarantee of municipal debt obligations, but, on the other hand, neither does it contain any explicit disclaimer. To date, this silence does not appear to have caused any confusion among market participants. Most lenders and investors appear fully aware that municipal obligations are limited in nature and do not carry an implied State guarantee.

Recommendations

- **Firstly**, the *Special Pledges Act* should be amended to expressly permit municipalities to register the pledges made to creditors, with that *Act* referenced in an article in the *Law on Municipal Credit* itself. This change is critical regardless of what forms of security are permitted. Creditors must have confidence that they can enforce their rights in the event of a loan default.
- **Secondly**, for the reasons articulated in Chapter II, government policy should encourage local governments and lenders to look to pledges of future revenues to secure municipal debt, rather than to rely on pledges of real estate or other property assets.

With this objective in mind, the municipal credit law should permit local governments:

⁵⁶ As noted above, the Svishtov bond issue is secured only with a general pledge on municipality assets and by the municipality's general obligation. However, according to interviews with Unity Invest, the bond's financial advisers, the City has initially proposed offering municipal property as collateral. They report that SSEC raised the question whether such collateral could be used, in part on the grounds that each individual bondholder should be able to identify what he would claim against individually. In the end, the municipality and the SSEC agreed that the collateral of the bond issue includes all of the assets of the municipality. Thus everyone who owns a bond could get a writ of execution that put the accounts of the municipality under restriction. Article 237(g) of the Code on Civil Procedure (added in 1997) states that agreements concerning stipulated obligations to pay pecuniary amounts are subject to compulsory execution. This provision would cover interest payments on municipal bonds because the issuance of such bonds was approved by a municipal council decision. Yet there is no experience with enforcing such a claim and the question of priority relative to other creditors has never been addressed or settled in the courts.



- (1) To secure debt with a pledge of shared taxes and own source revenues (including off-budget revenue sources as well).
 - (2) In connection with the above recommendation, to establish separate accounts on funds for segregating specific revenue sources dedicated to repaying specific credits.
- **Thirdly**, the Law on Municipal Credit should authorize local governments:
 - (1) On a voluntary basis, to enter agreements to provide for intercepts of these revenue sources when collected and transferred to them by the central government.
 - (2) With the express approval of the MoF, to pledge and authorize the intercept of central government subsidies as State aid intercepts.

Drafting of any intercept provision should proceed with great care. Intercepts are a proven and potent tool to help accelerate credit market growth, but they are also subject to abuse. Local governments get in the habit of relying on the intercept rather than maintaining the discipline of making timely debt payments on their own. And if the intercept law is too permissive, an ambitious mayor and council can tie up a disproportionate portion of a local government's main revenue sources for years to come.

In some countries, a different class of problems has arisen where the ministry of finance and private lenders cooperate too closely in the administration of intercepts. For example, the Ministry of Finance may make automatic payments to the commercial lender from a city's allocation of a shared tax, and then transfer only the residual funds remaining to the local government without any clear accounting for the intercept. To guard against this type of problem, it is important:

- That the local government not only enter the intercept arrangement voluntarily, but be in control of negotiating the specific terms and conditions.
- That there be clear conditions for when the intercept would be activated; the intercept should only operate to cure defaults, not to substitute for regular payments from the local treasury to the lender.
- That at a minimum, the central government be obligated to provide a clear accounting for any intercept funds diverted to a lender. Alternatively, intercepts can be administered through some special fiduciary arrangement established at the local level.

Moreover, to discourage municipalities from over-reliance on the intercept to cover delinquent debt payments, consideration should be given to imposing a financial penalty on the municipality each time a lender utilizes the intercept to cure a default.

BOX IV.5: EXAMPLE OF LANGUAGE ON SECURING DEBT WITH OWN SOURCE REVENUES

Republic of Lithuania, Decree on Usage of Bank Credits by Local Authorities, 1998

Article 14 – When taking a loan, the municipality must guarantee its repayment only by the means of the municipality budget, and the municipality enterprise, only by the assets, which could serve as a source to recover the loan.

Romania, Local Public Finance Law, 1998

Article 49. - (1) The due instalments deriving from the contracted loans, the interest and commissions due by territorial administrative units, shall be provided in the local budget.

(2) The loans contracted by territorial administrative units can be guaranteed by the local public authority, from any revenue source, with the exception provided under article 48, paragraph (3). Any guarantee by revenues is valid and shall apply from the moment the guarantee is offered; the revenues representing the guarantee and which are collected by the local budget shall be subject to the respective guarantee agreement, which shall apply with priority against any other request of third parties addressed to the respective local public authority, irrespective of whether these third parties are aware of the guarantee agreement or not. The document through which the agreement of guaranteeing through revenues is concluded must be registered with the city hall or with the respective judet Council, and with the debtor.

(3) All loan agreements concluded according to the provisions of this law shall be considered as fully authorised and shall constitute obligations to be enforced on the respective local budgets.

- **Finally**, to preclude any question of implied central government guarantee arising in the future, The Law on Comprehensive Credit (and other necessary legislation) should state that no central government guarantee is to be inferred for such credit unless there is explicit central government authorization. The *Municipal Credit Law* should require that each municipal debt instrument contain a statement on its face that there is not any express or implied central government guarantee and that the instrument does not represent any obligation of the central government. (An exception to this imperative would be made in the presumably rare instance when the government may choose to issue an explicit guarantee.) See Box IV.6 for sample language to this effect from another transitional country in the CEE region.



BOX IV.6: EXAMPLE OF LANGUAGE STATING THAT MUNICIPAL DEBT IS NOT AN OBLIGATION OF THE GOVERNMENT

Romania Local Public Finance Law 1998

Article 50. - (1) The local public debt does not represent a debt or responsibility of the Government and it shall be reimbursed exclusively from the revenues through which the respective loan was guaranteed by the authorities of the local public administration.

(2) The documents registering the local public debt shall include a clause through which the respective territorial administrative unit places itself under the obligation to reimburse the debt, and to pay the interest and the commissions associated with that debt exclusively from the revenues of the respective local public authority; the Government has no payment obligation whatsoever, and the credibility or taxation capacity of the Government must not be used for guaranteeing the reimbursement of the debt contracted by the territorial administrative unit or of the payment of interest or commissions associated with that debt.

(3) The documents registering the local public debt which do not comply with the provisions under paragraph (2) shall not be considered as valid.

5. Disclosure

Present Law/Practice. *Article 10(3) of the Municipal Budgets Act* provides that transactions in issues of securities and bonds shall be carried out by procedures under the *Securities, Stock Exchanges and Investment Companies Act 1995 (SSEIC Act)*, as amended. As noted above, since the research for this report was completed, the SSEIC Act has been replaced by a new *Law on Public Offerings of Securities* which took effect January 30, 2000 (*Securities Act*). This *Act*, as did its predecessor, sets rules for all shares and bonds offered to the public. The threshold for an offering to be considered "public" (and come under the purview of the Act's requirements) is that it be extended to at least 50 persons. (Article 4). It should also be noted that the Securities Act (as did the SSEIC Act) allows for private placements (i.e. offerings to fewer than 50 investors), but does not regulate them. Thus the requirement of *Article 10(3) of the Municipal Budgets Act* that the *SSEIC Act* requirements be followed has no specific content with regard to private placements of municipal bonds at the present time.

Both the *SSEIC* and the *Securities Acts* provide only for general disclosure requirements which apply to all public securities registered through the SSEC. The two Acts, and the Ordinance enacted pursuant to the earlier SSEIC Act, establish initial and continuing disclosure requirements for public offerings, including requirements for a prospectus to be reviewed and approved by the Securities and Stock Exchange Commission (SSEC). (See *Title Two, Chapter Six of the Securities Act, "Initial Offering of Securities"*). However, in so far as these documents contain specific requirements, they relate to "bonds" issued by "companies". As of yet, the SSEC has not established

guidelines that define appropriate disclosure for bonds issued by municipalities.⁵⁷ There are no specific requirements for a municipal bond issue. Present written procedures contain no recognition that economic and budget data for municipalities used to determine creditworthiness are in a different format than the data for commercial enterprises and should be examined using a separate set of rules and criteria. A review of the Svishtov offering document reveals that much of the required information was related to private corporate affairs and had very limited relevance to a municipal credit.

In the absence of appropriate disclosure requirements, the issuance and review process can prove frustrating and wastefully time consuming for both the SSEC staff, on the one hand, and the municipal applicant and its advisors, on the other. It should be noted that the SSEC, recognizing the need both to develop specific disclosure requirements for municipal bonds and to train its staff (and municipal staff as well), has arranged with the US SEC to provide the requisite technical assistance in the spring of this year.

Recommendations

Disclosure for Public Offerings. Clear, fair, and enforceable disclosure requirements are central to municipal credit market regulation and efficiency. They also have an impact on the costs of bond issuance and the willingness of private financial advisers and other financial intermediaries to take on the entrepreneurial risks of bringing municipal offerings to the market. Standardization in the disclosure requirements themselves (and predictability, timeliness, and professionalism in the review process), will go far towards encouraging municipalities and their advisors to invest the time and resources involved in successfully preparing and marketing a bond issue.

The Securities Act should be amended to direct the SSEC to adopt appropriate disclosure requirements for public offerings of municipal bonds. Such disclosure is important if the market is to act efficiently and for prospective investors to make informed decisions particular in regard to the nature and level of risk involved.

In designing disclosure regulations attention must be given to what information needs to be disclosed by whom, to whom, and when.

⁵⁷ The 1996 Ordinance on Prospectuses for Public Offering of Securities, issued under the SSEIC Act, gives specific rules for the contents of prospectuses for bonds. (Article 9). However, the data required assumes a corporate bond issue.



Scope of Pre-Sale Disclosure. In respect to the content of pre-sale disclosure, the following are illustrative of the range and types of information which investors should receive:

- Local government financial condition: budget characteristics (for two or three year period, including current); Description of off-budget accounts; all outstanding debt and other liabilities.
- Information germane to assessing the quality of security pledged for repayment.
- Characteristics of the local economy's structure and performance that significantly affect risk and prospects for repayment—for example, if local economic activity is highly concentrated in one or two large firms, then future tax revenues may be highly sensitive to the health of their business.
- Tax collection efficiency and (when applicable) fee collection efficiency.
- Any contingent guarantees extended to Municipally Owned Companies; other pertinent interrelationships between the municipal government and MOCs.

Somewhat different or additional requirements would pertain:

- To revenue bonds issued to finance a specific project with repayment predicated on the project's finances or a specific, related revenue source—rather than the creditworthiness of the municipality as a whole.
- Bonds issued on behalf of a Municipally Owned Company as opposed to a general purpose, local government.

Disclosure By Whom and When. The above type of requirements apply to the type of information to be provided in advance of sale to prospective purchasers of the given bond issue. Additional requirements would specify information to be filed upon actual sale of the securities. The regulation would also establish continuing disclosure requirements that would remain in effect until the debt is retired (most importantly, the borrower's obligation to inform the investors of any significant change in circumstances that would adversely affect the likelihood of timely repayment).

Some thought should be given as to whether the responsibility (in legal terms) for the quality and accuracy of disclosure rests with both the municipal entity itself and with the financial advisor or underwriter assisting with the bond issue—or primarily with the municipal issuer alone.

Disclosure for Private Placements. The primary legislation regarding municipal credit should specifically permit private placements, with standards to be set by the SSEC pursuant to the Securities Act. Private placements are more flexible and usually lower cost than public offerings. For instance, Poland has had more than 100 private placements of municipal bonds but only one public offering of such bonds.⁵⁸

The securities law in Bulgaria, as in many countries, contains no disclosure mandate for private placements of any kind. The premise for this omission is that private investors are “sophisticated” enough to ask the right questions, make informed decisions, and protect their own interest without regulated disclosure. Leaving private investors unprotected has proven workable when (as in the United States) the underlying law defines a series of tests for private investors to qualify as “sophisticated”. In some transitional countries like Poland, problems have already arisen with unregulated offerings to small numbers of investors on a private basis. We would recommend that the Bulgarian SSEC adopt some minimal disclosure requirements for private placements as well. These disclosure requirements should be simpler than those imposed for public placements. The disclosure documents should be self-certified for accuracy by the issuer and filed with the SSEC, but without any review and approval process. This would serve the valuable purpose in an emerging credit market of setting minimal standards for disclosure, but without creating a two-tier disclosure review and approval system that would negate the purpose of distinguishing public from private placements in the first place.

NOTE: To administer municipal bond disclosure requirements effectively, the SSEC will need to build the staff capacity to understand and review the offerings and disclosure statements on a timely basis. This will require professional skills in municipal and MOC finance and operations as well as in project specific financing for municipal infrastructure.

6. Prudential Investments of Proceeds

Present Law/Practice. The investment of “excess funds” of municipalities is presently limited to government securities and time deposits of banks in which the funds are on deposit. (Municipal Budgets Act, Article 23). It is apparently the practice to interpret “excess funds” to include the proceeds of borrowing.

⁵⁸ Here it should be noted that the threshold for a public placement in Poland is an offering made to 300 or more prospective investors (as opposed to 50 or more in Bulgaria). The question of whether, in the interest of increasing transactions, Bulgaria’s threshold should be raised, is one for overall securities market policy to address.



Recommendation

The present requirement is relatively restrictive, but given the scarcity of financial instruments in which to invest it is probably prudent. However, the language of Article 23 should be made more general to allow for similar other types of prudent investments. The term "prudential investment" should then be defined in an Ordinance issued under the Act.

7. Purchase and Resale of Bonds

Present Law/Practice. At present, there are no general rules regarding the purchase and resale of municipal bonds. However, conditions are found in the Svishtov bond issue on these matters and the SSEC appears to be acting by analogy to what is required for corporate bonds.

Recommendation

As noted earlier in the report, the likely emergence of a secondary market for municipal securities no doubt remains a number of years in the future. However, in formulating policy and law for municipal credit market development, Bulgaria would be well advised to do so in a manner that facilitates secondary market development when it becomes timely. Countries like Brazil which failed to do so have encountered problems in trying to remedy deficiencies in their credit market legal regimes retroactively. In Poland, commercial banks that have multiple municipal loans in their portfolios and wish to liquidate them to replenish their capital are having trouble doing so.

The regulatory framework should encourage standardization of documentation, particularly in respect to security arrangements. Such standardization allows financial intermediaries to bundle municipal credits together for resale to pension funds and other secondary market participants.

Rules should be established for the purchase and resale of municipal bonds based upon international practice. These rules should be set in the *Securities Act* itself, or in its implementing ordinances and regulations, with an appropriate cross-reference inserted in this proposed *Act on Municipal Credit*.

8. Lender Remedies in Case of Default

Present Law/Practice

Standing to Pursue Remedies. In the event of a default on a municipal bond issue, present law leaves bondholders to pursue remedies on an individual basis. Under most circumstances, this would prove impractical and needlessly costly and time-consuming to all parties involved. It also can constrain the type of collateral pledged

since it may suggest that collateral must be in a highly liquid form that would allow each bondholder to readily take possession of his share.

Form of Remedy. Above (B.4.c) we did point to the need to allow municipal borrowers to perfect pledges of collateral. With this one exception, the present legal framework appears to offer lenders to municipalities remedies in the event of default that appear adequate and appear comparable to those available for loans to private parties.

The rights to property, the rules of contract and obligations and the rules of foreclosure are set forth in the existing legal framework. (*Ownership Act, Obligations and Contracts Act of 1950, as amended*, and *Code on Civil Procedure 1950, as amended*.) The basic rules for holders of pledges and mortgages are set by the *Obligations and Contracts Act (Articles 149-182)*. Under *Article 160*, a creditor with a pledge may petition the court for a writ of execution on the basis of its contract. The rules for issuing writs of execution for mortgage deeds are set by *Articles 173 to 179*.

The rules for foreclosure procedures themselves can be found in the *Code on Civil Procedure*. *Part Four* concerns *Collateral Security Procedures (Articles 308 to 322)* and *Part Five* covers *Execution Proceedings (Articles 323 to 423)*. The writs of execution proceedings with regard to real property are found in *Articles 373 to 389*. The rules regarding claims for performance of financial debts generally are found in *Articles 337-422*. Under *Article 337*, the claimant may ask performance against any one property of the debtor. However, that property and rights must be liable to compulsory performance under other legal acts, as is not possible with regard to municipal public property. (*Article 339*).

Our interviews suggest that the system of enforcement through writs of execution seems clear to market participants, but rarely does this system proceed through its final steps. In practice lenders tend to prefer negotiated settlements, often because it would be difficult to sell the property foreclosed.⁵⁹ Thus there has been little, if any, experience with municipal default and court ordered, foreclosure of municipal private property. In fact, in the research for this report we learned of only one case of a non-performing municipal loan and that was paid within thirty days of its due date. The substantive and procedural defects of the enforcement system, if any, may only become apparent when there has been more experience with the enforcement of creditor remedies.

⁵⁹ In practice, writs of execution have been obtained against municipalities under the above provisions to collect debts owed to vendors and with regard to defaults on loans. However, the collection of moneys based upon such writs appears to be at the discretion of the municipality. In many cases, agreement is reached before a final judicial ruling.

Recommendation

Here at the outset, we should underscore that the type of well designed state transfer intercept recommended earlier, can provide lenders a more practical and reliable remedy in the event of default than enforcement of their rights through court action (or threat of such action).

Based on the above, at this time we do not see a need for a municipal credit law to deal in detail with the type of lender remedies available pursuant to the commercial code and other civil procure legislation. However, in respect to the bondholders' standing to act in the event of default, the legal framework law should permit them to act in an organized and effective manner to enforce their rights. This means that bondholders should be granted the right to pursue remedies in concert, and to be represented by a designated representative to act on their behalf who would have the recognized legal authority to do so. And these rights should be cited in the bond documents themselves.

9. Central Government Approval, Monitoring and Intervention

Present Law/Practice

Prior Notification and Approval of Municipal Debt Issuance. Present law does not explicitly require a municipal government to notify the Ministry of Finance before it borrows from a commercial source or to obtain the Ministry's prior approval. In practice, however, a municipality considering the issuance of debt tends to coordinate and consult with the MoF.

Any financial obligation of a municipality that may result in the financial obligation of the State to foreign creditors (e.g., a guarantee) must be approved by a resolution of the National Assembly on a motion introduced by the Council of Ministers (Municipal Budgets Act, Article 40(5)). In the event that the central government were to guarantee a municipal debt financed from domestic rather than foreign sources, then the Ministry of Finance, in the process of issuing its guarantee, would likely be approving the underlying transaction. However, this conclusion is not based on an explicit legislative requirement but merely the common sense conclusion that such approval would be a precondition for issuing the guarantee.

The Law on Transactions in Foreign Exchange Valuables and Currency Control (Article 12) (in effect until the end of 1999) required MoF approval for all rights and liabilities regarding foreign currency, unless otherwise provided in another law or by an act of the Council of Ministers. This requirement applied to any municipality seeking to issue its debt in a foreign currency. However, the new Foreign Exchange Act of 1999 (in effect from January 1, 2000) only subjects lending between local and foreign bodies to registration at the Bulgarian National Bank (see Article 4(2)).

Monitoring of Municipal Financial Condition. At present, monitoring of municipal compliance with legal requirements applicable to municipal debt and of municipal finance affairs generally (with intervention as needed) is done only on an ex post basis by two agencies: the State Audit Office at the Ministry of Finance, under the *State Financial Control Act* (at least every three years and a post-audit) and by the Supreme Chamber of Control attached to Parliament (pursuant to the *Audit Office Act*).

As the role of the audit agencies is not to monitor outstanding debt of the local sector, this task would normally come under the responsibility of the Ministry of Finance. However, the local government budget department of the MoF does not appear to routinely request information on amount and conditions of outstanding loans of local governments; the data, which is routinely available through budget reports, includes the annual amount of interest and principal payments.

At present, no form of oversight exists that would allow the central government to identify and possibly act in advance to delay or prevent a municipality from going forward with a loan that it clearly could not afford. In practice, and given Bulgaria's commitments to the IMF in respect of public sector debt and deficits, there is some justification for MoF oversight of both the extent of deficits at the local level and the amount of debt contracted by local governments. In preparation for EU accession, Bulgaria currently exceeds the Maastricht criteria limit for total public sector debt of 60 percent of GDP. Given the crisis in local government finance in 1999, the MoF is taking measures in 2000 to stabilize and improve the financial situation of local governments.

The Government of Bulgaria has signed a 3-year agreement with the IMF, which requires the Government to respect a certain number of "performance criteria", in order for financing under the Extended Fund Facility (EFF) to continue to flow. One of the most important criteria monitored by the IMF is the level of general government deficit, relative to GDP. For the 2000 fiscal year, the general government deficit should not exceed 1.5 percent of GDP.

In the perspective of limiting the public deficit, all borrowing, irrespective of the purpose for which it is contracted, is viewed as deficit financing. The IMF from the banking system side analyzes this performance criteria, by looking at financing below the line. In Bulgaria's case, this issue is especially critical, as the currency board means there is no longer any monetary instrument to adjust macroeconomic performance. Fiscal policy is the only instrument available.

To-date, one country in the CEE region, Poland, has established strict limitations on local government borrowing in preparation for EU accession. Nevertheless, the actual monitoring procedure is not spelled out in Law on Public Finances (See Box IV.7, below).



BOX IV.7: RESTRICTIONS AND MONITORING OF PUBLIC SECTOR DEBT IN RELATION TO GDP

The Case of Poland⁶⁰

Poland's Public Finance Law of 1998 introduced new cautionary limits on local government borrowings, in preparation for accession to the EU, and the necessity of monitoring and controlling the consolidated public sector debt.

The first limitation concerns the total outstanding debt stock of a local government, now limited to 60 percent of annual revenues (which is an extremely conservative limit, especially for large cities with strong fiscal bases).

The second limitation sets "cautionary limits" on local government borrowing if consolidated public sector debt exceeds 50 percent of GDP. In this case, the maximum borrowing of each local government cannot exceed the relationship between planned state revenues and planned state deficit for the fiscal year. Thus, if the state limits its borrowing to 10 percent of its current revenues, no local government can borrow more than 10 percent of its planned revenues. In the case the 50 percent is exceeded and the state decides to balance its budget, then no local government would be able to borrow anything at all.

Recommendations

In Chapter II, above (*Key Policy Considerations*), we cautioned against imposing prior central government review and approval for the issuance of municipal debt (other than for conformance with the disclosure requirements of the *Law on Public Offerings of Securities*). For the reasons cited there, the proposed Law on Municipal Credit would not provide for any advance MoF judgement on the financial soundness of a pending municipal borrowing. Nor would it provide for national level restraint on aggregate municipal debt nation-wide—at this point in time when the scale of municipal debt remains negligible and the few, creditworthy communities should be encouraged to consider using private credits to finance their investment needs. However, as detailed below, we do recommend that the proposed law require timely notice to the MoF both at the time of the initial issuance of any municipal debt and in the event of a serious default on a municipality's debt obligations.

Advance Notice of Borrowing. The law should direct municipal borrowers to notify the Ministry of Finance when a debt issue is imminent. This notice should be accompanied by certification and documentation that the terms of the pending credit will not cause the municipality to exceed the statutory debt limit. Such notification would

⁶⁰ This discussion is adapted from *The Political Economy of Fiscal Decentralization and Local Government Finance Reform in Poland: 1989-99*. Tony Levitas, Research Triangle Institute. July 1999. Prepared for USAID/The Urban Institute.

allow the MoF to maintain a current inventory of outstanding municipal debt, for purposes of both:

- Enforcing the municipal debt service limit itself.
- Monitoring aggregate municipal borrowing in conjunction with overall public debt management.

This current inventory could also be updated annually through improved municipal debt reporting practices as proposed below in the section C.2 on Reporting on Municipal Financial Condition. Moreover, it could also be maintained as a public registry open to prospective lenders to assist them in their due diligence when underwriting municipal credits.

Notice of Default. The law should stipulate that, in the event of a default on a municipal credit, both the municipality and the lender must give the central government “notice” of said default if the delinquent payment has not been made within 30 days of its due date. These provisions could be implemented in conjunction with specific procedures to handle municipal insolvency, as discussed in Section C.3 below.

10. Conclusions

Comprehensive municipal debt legislation that exclusively addresses all elements set forth above in an internally consistent manner would substantially benefit the development of the municipal capital markets in Bulgaria. The existing framework, in effect, is a patchwork: one must piece it together from language in a number of collateral laws, many of which only indirectly affect municipal debt. As such, it fails to provide the clear principles and guidelines most conducive to market development. The development of a new, comprehensive law on municipal debt would also offer the opportunity for the “stakeholders” in the municipal credit market to engage in joint policy formulation and consensus building.

In sum, we strongly recommend enactment of a new and comprehensive law. Should this law prove infeasible for political or other reasons, the alternative would be:

- **Firstly**, to reach agreement on the “essential elements” of the necessary legal framework.
- **Secondly**, to enact the framework through more piecemeal amendment of the respective laws that already governs municipal finance. For example, essential elements not addressed in existing legislation (such as “debt limits”) would have to be inserted into some remotely related law (e.g., the Municipal Budgets Act).



- **Finally**, it should be kept in mind that enactment of municipal debt legislation would not obviate the need to address related legal issues, e.g., issues relating to SSEC disclosure, the Special Pledges Act and banking reform, as mentioned above. In addition, changes would need to be made in other related areas, such as reform of the budgeting procedures, including the introduction of capital budgeting, reporting on municipal financial condition, setting of fees for municipal services, powers and responsibilities of municipal commercial enterprises, capital resources, and municipal bankruptcy. These related areas are discussed in the sections of this report that follow immediately below.

C. Recommendations on Municipally-Owned Companies

Present Law/Practice. The Contrast between Municipally-Owned Companies and Municipal Enterprises. Chapter III.C above contained a detailed review of the legal and financial status of Municipally-Owned Companies (MOCs), both in general and in respect to major areas of urban service and utility provision in which they are engaged. The discussion also pointed out that many of the same services can be (and are) provided by more traditional, Municipal Enterprises that function in effect as, sub-units of the general purpose, local government. These Municipal Enterprises possess no capital or other assets of their own; the revenues and expenditures associated with their activities are integrated into the overall municipal budget; they have no independent ability to borrow.⁶¹

By contrast, the MOCs, as independent companies organized under the *Commerce Act*, have a large amount of discretion in applying for and structuring a loan or a bond to fund an investment project. The MOC has the power to borrow on its own initiative (although, needless to say, the parent municipal government, as the sole or majority owner of the MOC would still exercise a de facto veto over any bank loan or bond issuance). Most importantly, like any commercial company, an MOC enjoys great flexibility in structuring security for any borrowing to satisfy a prospective creditor: the MOC can own and pledge its own assets, it can perfect a lien on behalf of a creditor, it can make both a general obligation pledge of all its financial resources or set aside any of its future revenue sources as security for a loan or a revenue bond. Moreover, an MOC, unlike a municipal government borrower, can file for bankruptcy *under Part Four of the Commerce Act*. This adds to the remedies available to a creditor should the MOC default on a debt obligation. It is important to note, that in general, Bulgarian law contains no distinctions between debt issued by MOCs and that issued by any privately owned business firm.

⁶¹ Chapter III.C discussed the recent amendments to the Municipal Property Act that confirmed and clarified the legal status of these Municipal Enterprises.

Tax Treatment of MOC Debt. In one respect, municipal governments that borrow on behalf of their enterprises can offer certain creditors more attractive terms than can an MOC. Unlike interest on municipal government debt, income earned on MOC debt held by *natural persons* receives no tax exemption. To-date, with most municipal debt funded through bank loans, this tax advantage has had no real practical consequence. However, in the future, if a market for municipal bonds grows among wealthy individual investors, it would provide a marketing advantage for municipal government bonds over those issued by MOCs.

Fees and Prices for MOC Services. As is evident from the above summary of MOC legal status, current Bulgarian law would pose no serious problems for an MOC borrower. At present, it is the weak condition of MOC finances, not their legal status, that constrains them from looking to the private capital market to finance their investment needs. The detailed review in Chapter III.C points to two reasons for MOC financial difficulties:

- **Firstly**, prices and fees for most MOC services still remain below levels needed to fully cover costs, including amortization of capital costs. And, even when prices have been increased significantly, MOCs confront both political and practical difficulties in collecting payments. Mention has already been made of several pieces of landmark legislation (most notably in the water and energy sectors) that offers some hope for remedying this situation in respect to several of the most important and costly urban services. Finally, it should be noted that the constitutional and legislative constraints on fee setting (as opposed to prices) cited earlier in this report, apply without distinction both to Municipally Owned Companies (MOCs) and Municipal Enterprises.
- **Secondly**, for legitimate reasons of public policy, the government and most local governments wish to continue subsidies of urban services (public transport, district heating, water and sewage) for persons judged as needing social protection. However, in most cases the MOC service provider must absorb all or most of this subsidy from its own operations. In practical terms, this means that to be financially viable (and a credit worthy borrower), the MOC would have to increase its tariffs even beyond the level needed to fund its operations in order to recover these subsidy costs from its other residential and business customers.

Recommendations

Section B of this Chapter set forth recommended provisions for a comprehensive Law on Municipal Credit that would govern borrowing by general-purpose local governments. The recommended legal reforms applicable to MOC participation in private credit markets are much more modest and narrower in scope.



The Public Stake in MOC Debt. Some of the central government concerns that might incline it to monitor closely and perhaps directly control the debt of general purpose, local governments, do not apply to the debt of Municipally-Owned Companies. For example, MOC debt is not included in public debt for the purposes of monitoring compliance with the EU's (Maastricht Treaty) limitations on public debt –except when guaranteed by the municipal government. That said, the *Commerce Act* should be amended to add a special language pertaining to Municipally Owned Companies that would recognize the special public interest in maintaining the financial viability of MOCs and constrain imprudent use of their borrowing authority. This new language would include provisions regarding credit that parallel those in the proposed Law on Municipal Credit with regard to: (1) special disclosure requirements; (2) requirements for level debt service; (3) limitation on the term of credit to the useful life of the investment financed, and, (4) prohibition of borrowing in a foreign currency without prior MoF approval.

Tax Treatment of MOC Debt. The Tax laws should make no distinction between general-purpose municipal debt and MOC debt if issued for any of the same types of public purposes. *The Taxation of the Income of Natural Persons Act* should be amended to extend the tax exemption on interest on government securities to that earned on MOC securities as well. Credit markets tend to mimic a country's tax structure. Without tax law neutrality between general municipal debt and special purpose MOC debt, the municipal credit market as it begins to grow will exhibit a built in bias against funding MOC investment.

Looking beyond legal provisions that would apply to the issuance of MOC debt itself, for MOCs to emerge as significant and creditworthy participants in the private credit markets progress on additional reform fronts is required:

- **Fee and Price Setting Discretion.** MOCs (with the support of their municipal government owners) must succeed in implementing the type of full cost pricing authorized by the recent legislation cited earlier (the new *Law on Consumer Protection and Rules of Trading 1999*, the *Waters Act 1999* and the *Energy and Energy Efficiency Act 1999*). Moreover, the recommended broadening of local government discretion to set rates for local fees (made in Chapter IV.D, below) should apply to MOCs as well for those public service charges treated as fees pursuant to the *Local Taxes and Fees Act*.

- **Transparent Subsidy Transfers to Finance Social Protection Objective.**
As a general policy, subsidies should be provided for commercial municipal enterprise services only through transparent transfers from budgetary organizations, including the municipality. The aim should be to provide as clear and transparent a separation as possible of:
 - On the one hand, the role of the local government as a majority shareholder of a Municipally-Owned Company organized as a commercial company to deliver public services on a business like basis.
 - On the other hand, its role as the unit of government responsible for seeing that all its citizens receive essential public services regardless of their ability to pay.

Such subsidies should be limited to specific social purposes, such as the transport subsidies for pensioners and children. This recommended separation of social subsidies from the revenues and expenditures associated with providing the service in question would help a prospective creditor more readily understand the underlying economics of the MOC's basic business operation.

D. Measures to Strengthen Municipal Creditworthiness

The priority recommendations involve measures to improve and stabilize municipal financial condition, to address deficiencies in reporting on municipal financial condition, and to address municipal insolvency.

1. Improving and Stabilizing Municipal Financial Condition

Many of the financial problems facing Bulgarian municipalities were discussed above, in the section on municipal creditworthiness. A number of changes which would improve financial condition and thereby, municipal creditworthiness, include in order of priority, (1) establishing a budget with separate operating and capital accounts, and multi-year capital investment plans, that would include the ability to carry forward surpluses; (2) granting greater local discretion to set fees and taxes; (3) instituting a more transparent and predictable system of transfers; and (4) allowing more local responsibility for the forecast of own source revenues.

a. Separate Operating and Capital Accounts and Move Towards Multi-Year Capital Investment Planning

Present law/practice. The present structure of municipal budgets is a disincentive to rational municipal financial management and to establishing longer term investment plans. Deficits of up to 10 percent of total revenues are permitted. Borrowing is viewed solely as a means to finance the deficit, and not as a revenue to finance



investment. This results from the lack of a distinction between the operating budget (expenditures and revenues) and the capital budget (expenditures and revenues). The Municipal Budgets Act contains some passing references to capital investment needs—for example, Article 8, directs that local budgets should specify appropriations for the “acquisition of long term assets”, and for “capital investments in business activity and support of enterprises for activities related to the needs of the municipality and the community”. However, in neither law nor practice is there provision for clearly separating out operating from capital expenditures. Nor is there any recognition in budget procedures that major investments need to be funded on a predictable, multi-year basis.

With the exception of Sofia and perhaps a few of the other largest communities, local governments do not appear to make any projections of their long-term capital investment needs. And, to the best of our knowledge, none at present have any form of institutionalized system for conducting such needs assessment on a periodic basis, establishing priorities among competing projects, and systematically relating these priorities to prospective sources of funding.

This lack of long term capital improvement planning is quite understandable under present circumstances. Local investment resources are so meager that they are readily consumed by relatively obvious emergency repairs and replacements needed to keep essential services and facilities in operating condition. Given these realities, investing effort in estimating and scheduling all major long-term investment needs might well feel like a meaningless exercise.

Finally, under the present rules established by MoF, there is uncertainty about whether a municipality can carry forward budget surpluses. There is also uncertainty about the ability of a municipality to retain operating savings realized through investments; they are more likely to be penalized through a reduction of central government transfers.

Recommendation

The budget system should move to a budget structure, which clearly differentiates the operating budget from the capital budget. This is an immediate need if municipal borrowing is to be encouraged at all, and one whose essential requirements can be implemented fairly readily by local finance department staff. Required budget formats should facilitate the type of creditworthiness analysis outlined in Box III.1, above. A balanced-budget system should end the open-ended budgeting process. Long-term loans should be recognized as a form of capital revenue to finance investment and thus part of the capital budget, and allowed within the limits proposed above (under Elements of a Comprehensive Law on Municipal Credit). Finally, the modernized budget system should allow surpluses and cost savings to be carried forward to the following budget year.



BOX IV.8: RULES FOR LOCAL BUDGETS IN OTHER EUROPEAN COUNTRIES (SEPARATION OF OPERATING AND CAPITAL BUDGETS)

France: Code Général Des Collectivités Territoriales

Article L.2311-1 The budget of a municipality is established with an operating section and an investment section, for both revenues and expenditures.

Hungary: Public Finance Act

CHAPTER V.- THE BUDGET OF THE MUNICIPALITIES

68/A. § The budgetary decree of the municipality, which includes the budget of the local minority councils as well and the budgetary resolution of the local minority councils contain the revenue and the expenditure estimates for operation and investment purposes separately within the budget.

BOX IV.9: RULES FOR LOCAL BUDGETS IN OTHER EUROPEAN COUNTRIES (BALANCED BUDGET)

France: Code Général des Collectivités Territoriales

Article L.1612-4 The budget of a local authority is in real balance, when the operating section and the investment section are respectively voted in balance, revenues and expenditures having been evaluated in a sincere manner, and when the transfer of revenues from the operating section to the investment section, added to own investment sources, except loans, is sufficient to cover the repayment of principal on loans, which fall due during the budget year.

Article L.1612-6 The budget of a municipality is not considered to be unbalanced when the operating section includes a surplus carried over by decision of the municipal council, or when the investment section includes a surplus.

Romania: Law on Local Public Finance (1998)

Article 4. - The preparation, approval and execution of budgets shall rely on the principles of local autonomy, unity, universality, balance, realism, and shall be annual and public.



**BOX IV.10: RULES FOR LOCAL BUDGETS IN OTHER EUROPEAN COUNTRIES (CARRY OVER OF
END OF YEAR SURPLUSES)**

Czech Republic: Budgetary Rules of the Republic

Article 25 (5): Surpluses in the financial management of the municipality at the end of the year shall not be forfeited.

Republic of Latvia: Law on Municipal Budgets

Article 4: Expenditures of the municipalities for an economic year shall not exceed the amount of financing made up of the revenues estimated for the respective year and the balance (remainder of funding) from the previous period.

For the longer term, local governments, particularly the larger ones, should look towards introducing a formal process for multi-year, capital improvement planning and budgeting. (See Box IV.11 for a description of the basic concepts.) In municipalities that rely on municipal credit as a major source of investment financing, the CIP and capital budget anchor the city's debt management upon a solid footing of mutually linked physical and financial planning. As such it bolsters the confidence of the prospective lender or bond purchaser that any given debt issue fits into a well-considered plan for meeting the community's overall debt obligations into the future.

At this point in time it would be premature to mandate the adoption of such procedures. Initially, they should be introduced through pilot programs in the largest cities that have sufficient resources to make this longer term, more sophisticated type of investment planning a meaningful exercise for local officials and staff. Over time similar practices could be introduced to other municipalities in a form appropriate to their respective size and level of investment activity.


BOX IV.11: CAPITAL IMPROVEMENT PLANNING AND BUDGETING: SOME BASIC CONCEPTS

The **Capital Improvement Plan (CIP)** describes a process for choosing, scheduling, and budgeting for public physical improvements on a multi-year basis. At the outset, all major municipal departments (1) periodically inventory their capital plant and assess its condition, (2) identify needs for new capital projects and major repairs and replacement to existing assets several years into the future, and (3) prepare cost estimates for alternative investment scenarios. City planning and budget staff manage a process for assessing trade-offs among competing needs, establishing city-wide priorities within a recommended level of capital spending that the community can realistically afford looking several years down the road. Considerations include:

- Investment in current needs versus those that will contribute to the municipality's longer term growth in its economy and its revenue base.
- The potential positive impact of recommended capital investments on the annual operating budget, as well as the potential for increased or new operating costs that may be generated by new capital investments.
- Trade-offs between maintaining, renovating, and replacing existing infrastructure and facilities as they age.
- The appropriate balance between "pay-as-you-go" investment financing (funded from current own-source revenues and transfers) versus "pay-as-you-use" debt financing, which spreads repayment over the useful life of a project.

Capital budgeting then is the annual process of selecting projects from the multi-year CIP and making definitive determinations of the recommended funding source for each.

b. Extend the Discretion of Municipal Governments and MOCs to Create and Set local Taxes and Fees

Present Law/Practice. As noted in the section on municipal creditworthiness, at present municipalities receive only a small part of their revenues from local taxes and fees. There are constitutional and legislative restraints on municipal discretion to raise local taxes and fees and to introduce new sources of revenues.

Provisions in Articles 60 and 84(3) of the 1991 Constitution state that the size of all taxes and fees shall be set by the National Assembly. Also Article 141(2) of the Constitution states that permanent sources of revenue of a municipality shall be established by law.

The *Law on Local Taxes and Fees of 1997*, as amended, sets the rate structure for each tax and fee named in that law: some in terms of a fixed rate—*Article 1(1)*; some in terms of a minimum/maximum range—*Article 1(2)*; and in the case of garbage collection, based on a cost-recovery formula.

Fixed rates and tax exemptions are set for the real property tax, the inheritance tax, the gift tax, the property transfer tax and the tax on transport vehicles. Those fees

for which there are minimum/maximum ranges include the fee for the use of kindergartens, day care centers and other forms of social services, the fee for holidays or medical treatment in a resort; the fee for extraction of quarry materials, the fee for technical services such as issuing of a building permit, the dog fee, the fee for purchase of grave plots, and the fee for safeguard and protection of agriculture plots. An exception is made for certain fees fixed for administrative services, such as marriage certificates.

The cost-recovery formula for the garbage fee includes the costs of providing garbage containers, collection costs, building, maintenance and operation of garbage depots, and the cleaning of public streets. (Article 66). Residential owners pay a specific fee based upon either a proportion of their real property tax assessment or the quantity of garbage that they produce. Non-residential property owners pay with regard to the number and type of garbage containers, or a proportion of real estate tax assessment if that number cannot be determined. (Article 67). The fee is paid simultaneously with the quarterly payment of the real property tax. (Article 64).

Beyond the local taxes and local fees specifically named in Article 1 of the Local Taxes and Fees Act, Article 2 of that Act states that the municipal council shall establish prices for all other services and rights. The rules regarding the setting of fees for water and sewer services, district heating, and public transport are set in special legislation. Recently, several landmark pieces of legislation have been enacted to require setting of charges for services based upon actual cost, including amortization. The actual approval of fees and charge is the responsibility of the municipal council, irrespective of whether the municipality carries out the service itself, or the service is provided by municipal enterprises that are commercial companies or by private companies.

For **water and sewerage**, the Waters Act of 1999 requires that the price charged for water services shall “cover the costs for construction, operation, maintenance and reconstruction of the systems and facilities required for the delivery of relevant services” (Article 193). Such prices shall cover only quantities of water actually consumed by users. After three years from enactment (July 28, 2002), the water service fee shall not include provisions for water losses which are over 25 percent of the total water produced by that company.

For **district heating**, the Energy and Energy Efficiency Act of 1999 provides that energy companies shall propose prices that take account of “economically justified costs”, including costs of protecting the environment, maintenance of fuel reserves and the recovery of economically justified investments, including those for repairs and rehabilitation programs and energy saving programs (Article 22). Such proposed prices may also include economically justified profit levels and costs resulting from additional obligations imposed by State authorized bodies. This formula will be used for setting district heating prices for 2001. The present State subsidy for district heating will end in 2001 (Article 95).

For **public transport**, *Article 5 of the Road Transport Act of 1999* states that public transport prices for passengers and goods/freight shall be set freely, depending upon demand and supply, by an Ordinance promulgated by the Ministry of Transport. That Ordinance is expected to provide for the recovery of all costs, except where specific subsidies are announced.

Recommendation

The above referenced legislative formula for the garbage fee and legislated ranges for some fees, suggests an apparently constitutional basis for amending the *Local Taxes and Fees Act* to provide for fuller local discretion to raise revenues. The major principle would be that fees cover all costs, including that for amortization of facilities. Such an amendment would permit municipalities to set all fees (and perhaps the Property Tax, as well) within specified ranges of levels, and to index those levels based upon inflation. Where applicable, municipal councils might be authorized to set fees based on full cost recovery principles. In the long-term, and as advocated by Prime Minister Kostov, the Constitution should be amended to authorize municipalities to set local tax and fee rates unilaterally and to permit them to set their own types of taxes and fees, based upon a law that authorizes optional sources of local revenues.

BOX IV.12: EXAMPLE OF LANGUAGE TO ALLOW TAXES TO BE SET WITHIN A RANGE OF MINIMUM AND MAXIMUM LEVELS

Romania: Law on Local Taxes and Fees (1994, amended 1997 and 1998)

ARTICLE 49(3)

The local taxes and fees applied as fixed amounts can be increased or decreased annually by local or county councils up to 50 percent. The adjustment decision must be adopted by October 31 of each year and it shall come into force starting with the next year. For taxes and fees due for 1999 the modifying decision can be adopted within 15 days from the issue date of the present Ordinance.

BOX IV.13: EXAMPLE OF LANGUAGE TO INDEX FEE LEVELS BASED ON INFLATION

Romania: Law on Local Taxes Fees (1994, amended 1997 and 1998)

ARTICLE 58

The local taxes and fees established as fixed amounts, the taxable assets provided in Annex 1, as well as the fines, shall be adjusted on an annual basis, by decisions issued by local or county councils by November, 30 of each fiscal year, on the basis of the inflation index covering a 12 months period ending on November 1 of the same year, and only if the increase is higher than 5 percent.



c. Improve Predictability and Transparency in System of Central Government Transfers to Municipalities and Build Incentives for Locally Funded Investment

Present law/practice. At present, there is little predictability and transparency in the system of central government transfers, both for general budget support and targeted investments. There are formulas and methodologies set for certain transfers which are promulgated in the State Gazette, but they are enacted together with the Annual State Budget Act. Additional central government funds are often made available to municipalities in the middle of a budget year on an ad hoc basis. This also suggests that there is some level of under-funding of municipalities. The transfer system discourages active efforts by municipalities to generate additional own revenue, as well as to improve services and make them more efficient.

Recommendation

The formulas which determine central government transfer payments to municipalities should be set in specific legislation (such as the Municipal Budgets Act), and not permit them to be changed annually in the yearly State Budget Act, which creates uncertainty and confusion.⁶² In Poland, the central government transfer formula has been included in the Law on Revenues of Local Governments. In addition, the formulas (particularly for Targeted Investment Grants) should include an element to encourage and reward, rather than discourage and punish municipal efforts to generate additional own revenues and to make locally funded investments in more cost efficient and performance-based services.

d. Forecasting of Own Source Tax Revenues for Budget Preparation

Present law/practice. According to the Municipal Budgets Act—Article 11(4)—estimates of own source revenues of the final draft budget of local governments should be based on estimates made by MoF. In application of this provision, the State Budget Act for 2000 requires the municipalities to incorporate in their budget estimates for the year 2000 the forecast of tax revenues calculated by the State tax services. Municipalities continue to retain estimating authority over fees, charges, municipal property revenues and other miscellaneous revenues, which account for less than 20 percent of total municipal revenues.

⁶² The value of the variables which are input into the formulas would continue to be determined each year in the annual budget, based on available funding and other factors.



Recommendation

Amend the Municipal Budgets Act to permit municipalities to use their own estimates of own source revenues⁶³, including local taxes and fees in budget preparation. Retain only budget review by MoF and Audit Office, as per Article 15 of that Act.

2. Reporting on Municipal Financial Condition

a. Accrued and Contingent Liabilities

Present law/practice. Accounting in Bulgarian local governments is based on cash accounting, and does not incorporate any practice of commitment accounting. As a result, it is now difficult for potential lenders to obtain an accurate and reliable picture of the financial position of municipalities, particularly with reference to accrued and contingent liabilities.

Recommendation

Cash accounting standards now in use should be modified to require that municipalities record purchases on a “when-incurred” basis. This type of “encumbrance” or “commitment accounting” represents a practical first step towards respecting a hard budget constraint and introducing full-scale accrual accounting down the road. In addition, reporting procedures should be developed to create a more direct link between the end of year accounting balance sheets and the annual budget plan, to identify accrued and contingent liabilities carried forward from previous budget years, as well as revenue received based upon obligations incurred in previous years. Another option would be to introduce fund type accounting systems and, over the longer term, program budgeting concepts.

b. Reporting on municipal debt

Present law/practice. There is at present no clear reporting on full outstanding debt and contingent liabilities of local governments; at most the only information provided in the budget is on total annual interest payments and principal repayments.

Recommendation

Institute a system of public debt reporting, to provide more detailed and complete information on outstanding debt issues (loans and bonds) of municipalities. This could be structured in different ways. Some examples include a specific and detailed annex required to be included with the municipal budget (such as practiced in France), or the

⁶³ As defined in Article 6(2) of the Municipal Budgets Act.



establishment of a public debt registry system, as has been planned for Romania. In any case, Bulgarian municipalities should be obliged to provide detailed information on each outstanding loan and bond, including amount borrowed or issued, debt stock, structure of interest rate and structure of debt payments, purpose for which debt was contracted, etc.

BOX IV.14: EXAMPLE OF INFORMATION PROVIDED IN THE DEBT ANNEX OF FRENCH LOCAL GOVERNMENT BUDGETS

Every budget presented to the local, county or regional councils in France (as well as to councils of local government associations) must include a Debt Annex, with the status of all outstanding loans on January 1 of the fiscal year:

*Information to be listed in the annex, for **every loan and bond outstanding***

- Year loan was contracted / bond issued
- Bank or financial institution which provided the loan
- Amount of principal borrowed / debt issued
- Purpose / project the loan was used for
- Maturity of loan / bond
- Currency and rate, if loan / bond is in foreign currency
- Interest rate (indicate if fixed or floating)
- For floating interest rate, index used to determine the rate
- Payment schedule (annual, semestrial, quarterly or monthly payments)
- Grace period (number of months, years)
- Principal outstanding on January 1 of the fiscal year
- Interest payment for the fiscal year
- Principal payment for the fiscal year
- Principal outstanding on December 31 of the fiscal year

An annual total is calculated for the last four items above.

This data is also required to be provided for loans guaranteed by the local government to a third party, with the name of the beneficiary of the guarantee.


BOX IV.15: EXAMPLE OF REQUIREMENT FOR A PUBLIC DEBT REGISTRY - ROMANIA

NOTE: THIS IS THE TEXT OF ARTICLE 52 OF ROMANIA'S 1998 LOCAL PUBLIC FINANCE LAW.

Article 52. (1) The total amount of the debt contracted by the local public authority shall be put down in the register of the local public debt of the local public authority and shall be reported annually through annual accounting reports.

(2) The register of the local public debt shall include information on the total amount of the debt incurred by the local public authority, as well as a detailed account of the debts, and other information established through methodological norms regulating the register of the local public debt issued by the Ministry of Finance.

3. Dealing with Municipal Insolvency

Present law/practice. There are comprehensive bankruptcy provisions in the Commerce Act, (Part 4, Articles 607-760) which apply to municipal enterprises, as commercial companies. Municipalities are exempted from these provisions because they are not merchants as defined in the Commerce Act (see Articles 1 and 2). Therefore, there is not at present a system (law or established procedures) for dealing with the affairs of an insolvent local government and its relationships with creditors (or of a subsidiary municipal enterprise whose financial problems may have precipitated the insolvency). It should be noted that the lack of a system for addressing municipal default is not unique to Bulgaria; there are currently only two countries in Central and Eastern Europe that have elaborated specific procedures to address municipal default: Hungary and Latvia. Romania's Local Public Finance Law includes some provisions to deal with municipalities who have defaulted on their loan obligations. Few, if any, Western European countries have directly addressed the issue in their respective legislation.

A municipality which defaults on debt and other payments has likely overestimated its financial capacity, allowed expenditures to increase at a faster pace than revenues and in general, has poor financial management. In order to build a stronger financial base, such a local government likely requires assistance and support to establish good financial management policies and practices.

Given the poor performance of municipal finances in the past few years, and the crisis situation in late 1999, the Government is also concerned that local government financial management will negatively impact on Bulgaria's public deficit performance (a key performance criteria under Bulgaria's IMF agreement). To begin to address this situation, negotiations for the 2000 budget between the MoF/Council of Ministers and the National Association of Municipalities in the Republic of Bulgaria (NAMRB) have resulted in an agreed protocol for short- and medium-term measures for municipal restructuring. In order to ensure release of national subsidies in 2000, each municipal council must prepare and adopt, and the MoF approve, a program for financial



stabilization and efficient management of resources. The program requires local governments to meet short- and medium-term restructuring objectives, which include:

By December 15, 1999

- Identify municipal functions which should be discontinued, and reduce associated staff by January 1, 2000;
- Restructure other municipal functions and reduce staff as of January 1, 2000;
- Reorganize functions on a corporate basis, as may be necessary;
- Restructure municipal administration and reduce staff by at least 10 percent;
- End “unauthorized” subsidies from the municipal budget to loss-making enterprises;
- Review all lease agreements, and renegotiate lease contracts not beneficial to the local government;
- Terminate funding and freeze capital projects of low priority, as well as current and capital repairs.

By March 31, 2000

- Accelerate completion of privatization, using an open privatization process;
- Initiate liquidation or restructuring of loss-making municipal activities;
- Set up a joint tax administration and municipal commission to conduct massive audits of tax evasion, and non legal activities;
- Set up joint regional healthcare and municipal commission to inspect needs, supplies, and prices of medical supplies.

Furthermore, municipal officials must declare that they will spend allocated funds only on priority expenditures, as determined in the State Budget Act.

Requiring a greater level of budget and financial discipline by local governments is in and of itself not a bad idea to promote, and in the longer term may help stem the risks of municipal default. However, the system in which local governments continue to operate still provide the same incentives and disincentives as before, as the other laws and regulations have not changed.

Recommendation

Law and procedures should be developed for managing the affairs of an insolvent municipality and its relationships and rights with regard to creditors, and the priorities among them. The procedure should also include establishment of a set of policies to assist the local government to regain a stable financial position. Such procedures could build on some of the ideas of the 2000 budget protocol, but will also need to operate in a system with greater incentives and hard budget constraints for responsible municipal financial management, as proposed in the preceding sections.



Depending on the rules which are adopted, such procedures could be initiated by the council of Ministers, the local government itself, or eventually the municipality's creditors. The definition of municipal insolvency, as well as the rules and conditions under which a procedure to address municipal insolvency may be engaged should be very clearly determined.

Examples of the processes established in Hungary, Latvia and Romania are provided below. They are very different; Hungary relies on the court system, with almost no actions by the Ministry of Finance or the Ministry of the Interior (responsible for overseeing many local Government Issue in Hungary). The process in Latvia relies more on the Ministry of Finance. In both cases, a supervisor or trustee is appointed to assist the municipality to prepare a financial remediation program and to supervise implementation of this program. Both Latvia and Romania offer the possibility of low- or no-interest financial facilities to aid in implementing the financial stabilization program. In France, a form of financial stabilization procedure (financial protocol), including increase in rates of local taxes, and reduction of expenditure, is often required by the Crédit Local de France as a condition for additional guaranteed loan financing for local governments in difficult financial positions.

BOX IV.16: EXAMPLE OF PROCEDURE FOR DEBT ADJUSTMENT AND TO ADDRESS MUNICIPAL INSOLVENCY - HUNGARY

Note: This text describes the debt adjustment / municipal bankruptcy process for Hungarian municipalities, based on the provisions of the 1996 Municipal Debt Adjustment Act.

The debt adjustment process may be initiated by either the municipality or by its creditor, through a court petition. The condition for meeting a 'default' situation is defined from the point when an invoice or call for payments, or an acknowledged debt has not been paid within 60 days, or an obligation required by court decree is not met, or an obligation resulting from a previous bankruptcy decree is not paid.

Once a series of notification conditions have been met by the mayor / city council and the creditor, and the court determines that default conditions do exist, a financial trustee is appointed by the court. Among the responsibilities of the financial trustee is to monitor the business operations of the local government and ensure the provision of mandated public services. All obligations and payments must be signed by the financial trustee. In addition, the bank of the local government cannot enforce any liens or make payments without the countersignature of the trustee.

Legal consequences of the debt adjustment process from the point of view of creditors include the following:

- All debts become due;
- All claims continue to accrue interest and penalties;
- Debts must be reported within 60 days to the financial trustee; if a creditor misses the deadline, an extension is not possible and there can be no enforcement of the debt until 2 years after completion of the adjustment process then under way.

The actions of the municipality are severely limited once the debt adjustment procedure has been initiated. In particular, the municipality may not:



- Assume additional debt;
- Create new enterprises;
- Purchase ownership interests in enterprises.

A debt adjustment committee is formed, composed of the financial trustee, the mayor, the notary, the head of the council finance committee and an additional council member. The committee prepares a draft emergency budget, including the detailed listing of mandatory public functions and their financing. However, even in this sphere there are severe limitations, as the emergency budget will not fund public health, social and educational facilities with a usage rate of less than 50 percent, or facilities whose costs are more than 30 percent higher than the national average.

Compromise negotiations are initiated to define the reorganization program and the debtor-creditor agreement. The compromise is submitted in writing to the court. If it meets the requirements of the Act, the debt adjustment procedure will be completed and the compromise published in the Enterprise Registry. The implementation of the compromise may be supervised by the financial trustee. A compromise agreement may include liquidation of some assets of the local government.

BOX IV.17: EXAMPLE OF PROCEDURE FOR FINANCIAL STABILIZATION TO ADDRESS MUNICIPAL BANKRUPTCY - LATVIA

Note: This text describes the financial stabilization/municipal bankruptcy process for Latvian municipalities, based on the provisions of the 1998 Local Government Financial Stabilization Act.

The Local Government Financial Stabilization Act lists three conditions which may be the basis for financial stabilization action: 1) the inability of the local government to settle its debt commitments; 2) a value of debts which exceeds the market value of local assets; and, 3) a debt service ratio greater than 20 percent.

A financial stabilization process may be initiated by the troubled local government, on recommendation of the chairman of the municipal council, the Minister of Finance, the Minister of Special Assignment, or the State auditor. The municipal council must adopt (or reject) the proposed application for a stabilization plan. In case of rejection, the Cabinet of Ministers may determine that the local government should nevertheless enter a stabilization program.

The Stabilization Act directly proposes different options which local governments should review while carrying out their stabilization plan: improving tax collection capacity; promoting regional development; advancing the question of amalgamation⁶⁴; privatization of municipal assets; and, identifying cost efficiencies to reduce local expenditures.

A Supervisor is appointed to assist the local government in developing and implementing a Stabilization Program. The role of the Supervisor includes making proposals to improve the budget (which should include finding cost efficiencies to reduce local expenditures), proposing amendments to the Stabilization program, monitoring budget implementation to ensure compliance with the terms of the Stabilization plan. At the request of the Minister of Finance, the Supervisor can also control all municipal expenditures and sign the municipality's payment orders.

BOX IV.18: EXAMPLE OF PROCEDURE TO ADDRESS MUNICIPAL DEBT DEFAULT: ROMANIA

⁶⁴ This is an issue specific to Latvia, a country with 2 million inhabitants and over 500 local governments. Current policy is to encourage rural towns to merge.



Note: This is the text of Article 54 of Romania's 1998 Local Public Finance Law.

Article 54. - (1) The activity of the authorities of the local public administration shall be subject to exceptional check ups run by the Court of Accounts, according to the provisions of this article, in the following circumstances:

1) The local public authority does not reimburse all its short term debts by the end of the fiscal year during which the loans were contracted;

2) If at a certain moment during the fiscal year the short term debts of the local public authority are higher than the limit specified under article 53, paragraph (2), point 1).

(2) The Court of Accounts shall request to the local public authorities which fall under one of the conditions specified under paragraph (1) to draw up and submit a remedy plan according to which the local public authority binds itself to comply with the provisions of article 53, paragraph (2) within twelve months.

(3) The Ministry of Finance can grant loans to local public authorities running the remedy plan, out of the available funds in the general account of the state treasury, provided the local public authority binds itself to reimburse these funds within a term set up by the Ministry of Finance, but not longer than two years.

E. Related Issues and Recommendations

1. Investment Grant Design and Administration

Present Law/Practice. As summarized in Section III, several government programs subsidize municipal investments, most notably the targeted investment funds administered by the Ministry of Finance, and the grants and interest free loans administered through the National Environment Fund.

Targeted Investment Subsidies. Allocation of Targeted Investment Subsidies proceeds on a subjective basis with little predictability for municipal applicants. The Ministry of Finance has established priority sectors for funding that mirror the four sectoral priorities in the National Development Plan and reiterated in the annual State Budget Law: water supply, health care and social welfare facilities; educational facilities; environmental enhancement. However, these priorities are communicated more as guidelines for the types of projects the MoF wishes to encourage, rather than as formal eligibility criteria. Municipalities remain free to request funds for virtually any investment purpose, and their annual applications cover the gamut of local capital needs. The MoF reportedly funded projects in a number of lower priority sectors such as roads and low-tension, electrical distribution networks. Regardless of sector, preference quite reasonably is given to projects that are underway and nearing completion. In respect to level of funding, the amount of investment subsidy allocated to any given municipality appears arbitrary, except to the extent that prior year allocations tend to establish a precedent for subsequent years.



National Environmental Protection Fund. By contrast, the National Environmental Protection Fund provides municipal grants for 70 percent of the cost of wastewater and solid waste projects with a 30 percent local match. In addition, MOCs can obtain interest free loans for equipment purchases (e.g., water purification devices, garbage compactors). Typically, loans extend for two to five years with a one to two year grace period. Application for such interest free loans must be accompanied by both a commercial bank guarantee of repayment and 30 percent co-funding from the MOC.

At present, direct government lending to municipalities (as opposed to MOCs) is limited to the short-term financing of cash-flow deficits. Based on newspaper and anecdotal accounts, there appears to be a pattern of ignoring defaults on such loans and, after the passage of time, absolving the municipal borrowers from their repayment obligation.

Recommendation

As a rule, we would recommend that the enabling legislation for investment grant or loan programs should:

- Reflect clear sector priorities with funds for any given program targeted to two or three sectors at most.
- Provide that funds be allocated based on a formula or other criteria that are clear and transparent.
- Build in incentives that encourage local investment rather than having the availability of government grants substitute for local funding of projects. This argues for having explicit matching fund requirements that specify a given ratio of local investment to the amount of government funding received, or having local governments compete for government grants based in part on the amount of local funding they bring to the table. Here the Environmental Protection Fund provides a good model.
- Fund approved projects on a multi-year basis consistent with the years needed to complete them.

Moreover, the administration of loan programs should impose the same standards of timely repayment of indebtedness as would be imposed by private lenders. (These principles were elaborated in Chapter II, Key Policy Considerations, above.) Where enforcement of repayment becomes lax, and government loans degenerate into *de facto* grants, it can weaken the sense of local financial discipline and accountability to creditors needs for private credit markets to function.



In the near term, given the paucity of investment resources at the local level, the targeted subsidies function as a critical, general purpose budget supplement for local governments. Under the circumstances, the MoF openness to at least consider applications for virtually any type of investment project may be warranted. And, at present, most municipalities would face serious constraints in funding even modest, matching fund requirements.

In conjunction with the ongoing review of overall policy and the legislative framework for intergovernmental transfers, consideration should be given to modifying the Targeted Investment Subsidies in line with the program design criteria outlined above. One hopes that over the next five years progress will be made in strengthening the own-source revenue base for local government. Assuming such progress, government investment grants should be targeted more narrowly to advance a few sectoral priorities. It may make sense to channel all government investment subsidies through sectoral specific programs such as the Environmental Fund in lieu of retaining a more general, investment subsidy program. This type of concentration allows the government staff administering such grants to develop the specialized expertise (be it in educational facilities, wastewater treatment) to better evaluate and screen applications on their merits. And, as local budget resources grow, matching fund requirements should be considered for all government investment subsidy programs.

BOX IV.19: HUNGARY - MULTI-YEAR ALLOCATIONS OF TARGETED INVESTMENT SUBSIDIES

Major infrastructure investments at the municipal level require more than one year to implement. The tendency in most post-communist countries has been to start a project and finance it on a pay-as-you-go basis, as funds become available, thus adding 2-5 years of time required for project completion. Part of the limitation has been the lack, to date, of long-term funding (that is, more than 5-7 years), as well as multi-year commitments of centrally distributed targeted subsidies.

In almost every country, targeted grant systems will only ensure project financing for one calendar year, requiring municipalities to re-apply to receive funding for the same project in subsequent years.

The single exception has been Hungary, where targeted investment subsidies, including through special Funds (environmental, water, roads) and subsidies issued by Parliament are awarded on a multi-year basis. Approval of an investment project for financing will imply an overall earmarked amount (representing from say 30-60 percent of total project costs), over the time it will take to implement the project, with an annual disbursement schedule. If all funds scheduled for disbursement are not drawn down in that year, they may be carried over to the subsequent budget year – the key is that the total approved funding in the multi-year (usually 3-year) period is not increased.

This system provides assurance to the local governments that funding will be available over the period needed to implement the project, obviates the need to fill out time-consuming applications each year and makes it easier to find complementary sources of financing, including loans.

2. Other Financial Sector Laws and Regulations



As detailed in Chapter III, above, at present, and over the near term, the commercial banks remain by far the most important prospective source of private capital for the municipal sector, but with the pension and insurance industries poised to grow in importance over the years ahead. Reference has been made above to the need for disclosure requirements in the laws and regulation that govern participation in the securities markets for all participants. This section turns to the laws and regulations that directly regulate each of these three classes of financial institutions, individually. At the outset, however, it should be noted that here the study did not identify any major problems *specific* to municipal credits, per se. Rather, the constraints identified apply more generically to all types of secured lending.

a. Banks

Present Law/Practice. Although the volume of bank lending to municipalities to date is small, banks face no restrictions on the portion of their portfolios that they can allocate to municipal loans (or bonds). Several municipal officials interviewed for this study reported having given up on negotiations for banks loans because of what they perceived as unreasonably high requirements for collateral relative to loan value—cited as often being in excess of 200 percent.⁶⁵ Our research did identify two areas of commercial bank control that were seen as explaining such collateral requirements, as, in general, inhibiting of lending activity (to all borrowers, including municipalities) and as contributing to the unusually high liquidity in the banking sector referred earlier in this report:

- **Firstly** are *Sections (2) and (3), Article 220 of the Criminal Code of 1968, as amended*. These provisions impose criminal penalties of up to ten years in jail on those [banking officials] who are found responsible for making loans which are defaulted upon by the borrower and for which "adequate" collateral has not been provided to repay the loan in full. This provision has understandably made those bank officials responsible for credit decisions reluctant to assume such responsibility, and if loans are approved, may well result in excessive collateral being required from the borrower.
- **Secondly** is Banking Regulation No. 9, *on the Evaluation of Risk Exposures of Banks and the Allocation of Provisions to Cover the Risk Related Thereto*. This regulation sets up a classification system relating to the "level of risk" exposure to the bank, primarily based on the period of time for which payments are in arrears. Article 13 of this regulation allocates various reserve

⁶⁵ The collateral level for municipal loans is typically set at 125 percent of the loan value. (see Article 14 of Regulation No. 8 on the Capital Adequacy of Banks issued in 1997.) However, in practice according to a number of interviewees, the lender will then value the collateral at 50 percent of its market value. The apparent result is that short-term municipal loans issued for less than one year may end up being secured by mortgaged real property with an actual value of almost two and one-half times the loan value.



requirements for banks depending on the level of risk exposure, ranging from 3 percent for standard risks to 100 percent for risks that have been determined to be a "loss", i.e., more than 180 days past due. These reserve requirements were repeatedly mentioned by representatives of the banking community in our interviews as substantially adding to the cost of making loans. At the same time, the reader should note that the Bulgarian National Bank (BNB) adopted these regulations in response to the financial crisis from which the country has only recently emerged, and that they are given credit, with some reason, for the relative stability and solvency that the banking sector has enjoyed over the past two years.

The substantial collateral and reserve requirements could, in the future, tend to make the purchase of municipal bonds more attractive to banks than primary lending to municipalities. To date, the bonds being issued have been unsecured and banks need only reserve against them as "investments" rather than as loans.

As a final note on the above two financial sector controls, it should be noted that they apply to all lending activity, and in no way disadvantage the municipal sector relative to the other economic sectors for which it competes for capital.

Recommendation

Reserve Requirements. On the whole, the type of reserve requirements imposed by the BNB are consistent with typical and prudent bank regulatory practice elsewhere in their provisions for portfolio surveillance and the establishment of loss reserves based on the likelihood of loss. Given the banking industry's recent troubles, the conservatism of these reserve requirements is understandable and does not discriminate against the municipal sector. Perhaps the specific percentage reserve requirements should be reviewed relative to international standards with consideration given to counting a percentage of the market value of liquid collateral as a credit to the reserve requirement.

Criminal Sanctions. Clearly in the absence of fraud and collusion, reasonable bank lending activity should not be subject to criminal penalties in the event of default and insufficient collateral. *Article 220, Section (3)* (which was added to the *Criminal Code* only in 1997) should be repealed. The American Bar Association CEELI Project made a comparable recommendation. To minimize the need for criminal sanctions CEELI has also advocated more emphasis on preventative measures, such as the training of bank officers, combined with examination of a bank's operation through capital adequacy requirements, improvement of collection of claims and execution of collateral, and strengthened bank supervision. *Articles 220(1) and 282* of the *Criminal Code* would remain in place to provide a "due-care" standard in establishing reckless behavior and/or substantial loss as a result of such conduct. In most countries, similar



rules have been found to provide sufficient protection against irresponsible banking practices, as long as the standards are clearly defined.

That said, it is difficult to predict whether or not repeal of the *Article 220* sanctions, in and of itself, would result in a noticeable relaxation of bank lending practices and more active underwriting of bank credits (including loans to creditworthy municipalities).

b. Pension Funds

Present Law/Practice. Under *Article 44 of the Supplementary Voluntary Pension Insurance Act*, municipal bonds are one of the permitted investments of a voluntary pension fund. Not less than 50 percent of the assets of such funds shall be invested in securities issued or guaranteed by the government, and/or in receivables on demand on bank deposits. Government securities, as defined, include municipal bonds. There is no other limitation on their investment in such bonds.

Recommendation

The present legal framework regarding pension funds encourages investment in municipal bonds that are prudent investments. A number of the recommendations made above (the adoption of disclosure rules for such bonds, and full range of measures to strengthen the creditworthiness of the municipalities and MOCs that would issue them) would be major steps in improving their attractiveness to pension fund managers.

c. Insurance Companies

Present Law/Practice. *The Insurance Act 1996, as amended*, permits insurance companies to invest their insurance reserves in low risk instruments that are enumerated in a comprehensive list. *Article 52(1)* of the Act provides that an insurer may invest his insurance reserves only domestically in six types of investment, of which one is bonds issued or guaranteed by municipalities. The law limits such investment to five percent of those reserves. However, present portfolios of insurance companies are comprised basically of State securities and bank deposits. Thus, for the near term, this five percent limit does not pose a practical constraint on the purchase of municipal bonds for inclusion in insurance reserve accounts. Moreover, it should be noted that, on average, insurance reserves for both life and non-life firms constitute just under 50 percent of total insurance company assets.⁶⁶ The law contains no restriction on the portion of non-reserve assets that could be invested in municipal credits.

⁶⁶ Annual Report of Insurance Supervision Directorate, 1998.



Recommendation

The Insurance Act already provides for investment in municipal bonds. Thus the essential legal prerequisite is in place. As part of any overall review and revision of the Insurance Act that may be forthcoming in the future, the five percent limit (on municipal bonds as a per cent of reserves) might be reviewed and consideration given to enacting a modest increase (perhaps to 10 percent) or to shifting to a limit defined along the more flexible lines contained in the pension fund legislation described above.

V. CONCLUDING NOTE: RELATED INSTITUTIONAL DEVELOPMENT NEEDS

The recommendations developed through this report focus on the legal framework for municipal credit market development. The reader should keep in mind that to progress from laws to a fully-functioning credit market will necessitate concerted attention to related institutional development within both the public and private sectors. Most of these have already been alluded to in passing above, but are recapped and underscored in this concluding section.

1. Public Sector Institutional Development

In respect to related public sector institutional development:

- **General Purpose Municipal Governments.** A major finding of this report was that, with the exception of Sofia and perhaps a few other of the largest cities, virtually no Bulgarian municipality at present generates the surplus in its operating budget that would qualify it as a borrower able to afford taking on long term debt commitments. The recommendations presented in Section IV.D, above, link the development of creditworthy municipal borrowers to further progress on the broader fiscal decentralization agenda. Needless to say, strengthened fiscal autonomy at the local level will necessitate municipal governments introducing new systems and procedures and augmenting their staff capacity on a broad array of management fronts. Some examples that apply particularly to capital investment financing:
 - Assuming that the central government resolves to grant increased revenue authority to local governments, making use of this authority will require new and improved institutional capacities in respect to the setting of local taxes and fees (and perhaps, aspects of their administration).
 - The introduction of meaningful, long term capital improvement planning and budgeting will necessitate the engagement of finance department, urban planning staff, and the staff of city line agencies with each other in new ways, through a structured process linked to the annual budget cycle. Moreover, municipal councils will need to be educated to capital planning and budgeting concepts, and their role in capital budget review and approval.
 - Senior finance department staff will need to develop new skills in structuring debt obligations, negotiating with prospective suppliers of credit and with financial intermediaries, and in ongoing debt management.
 - In conjunction with increased MOC financed capital investment, local governments must strengthen their systems and staff capacity for overseeing and regulating MOC tariffs and operations.



- **Municipally-Owned Companies (MOCs).** Chapter II raised the possibility, in the context of more operable and decentralized form of governance, the shift of responsibility for more urban services to MOCs from both general purpose, municipal governments, and from State controlled companies. The prospects for financing a significant portion of local development needs through MOCs is inseparable from the long term progress these institutions must make to operate as truly, self-financing businesses. This requires continued improvement in linking rate setting to more sophisticated cost accounting that allows for the full costs of amortizing and maintaining capital investments.
- **The SSEC Role.** As noted above, the SSEC must develop a professional staff capacity to administer municipal bond disclosure requirements. This involves not only the specialized professional skills to perform the review and approval of initial offerings but also the capacity to oversee requirements for continuing disclosure as problems with bond repayment may arise over the life of any given debt issue.
- **Other Central Government Institutions.** At a minimum, the central government will have to administer the three registration and notification requirements recommended as part of the municipal credit law: (1) registration of initial debt issuance (and monitoring for conformance with debt service limitations); (2) registration of municipal pledges, and (3) notification of prolonged loan defaults. Administration of the second of these can most likely be integrated with relative ease into the existing system for registering pledges from private sector borrowers. The first and third functions will require the creation of new capacities within the Ministry of Finance or other appropriate agency. Furthermore, the authorization of some form of revenue intercept would necessitate some associated staffing and administrative burden.

In support of the above functions, the MoF may want to augment its ability to monitor the finances of local governments on a more ongoing basis and to perhaps maintain some form of informal early warning system.

If, contrary to the recommendation of this report, the government opts to legislate formal advance review and approval of municipal credits (in effect substituting its credit evaluations for those of the private sector), the implication for capacity building and human resource development within the Ministry would be far more formidable.



2. Private Sector Institutional Development

On the private sector side, the success of the recommended reform strategy will rest in large part on the development of the institutional competence within participating private entities to exercise proper due diligence and informed caution before extending credit to municipalities and MOCs.

- **Commercial Lenders.** Commercial banks and other financial institutions that may engage in primary lending to municipalities will need to develop the specialized staff capacity to underwrite municipal credits. Evaluating municipal creditworthiness is a very distinct task from assessing a loan application from a private business for its working capital or investment needs.
- **Bond Credit Rating Organizations.** The recommended reform strategy assumes that, as the volume of municipal bond issues increases, one or more qualified firms will recognize and pursue the rating of municipal credits as a profitable business opportunity.
- **Municipal Bond Underwriters and Financial Legal Advisors.** In a fully developed municipal bond market, a number of financial institutions specialize in bringing debt issues to market either as financial and legal advisers (paid on a fee for service basis) or as underwriters who assume some risk of their own in making a market for the bonds they promote.

Given the embryonic stage of the municipal credit market development in Bulgaria, the opportunity remains for orderly institutional development in advance of significant volumes of borrowing materializing. At the same time (as emphasized in Chapter II, above), public policy should be aware that the evolution of the capital supply side of the municipal credit market may have to transcend some “chicken and the egg” dilemmas of institutional development before it could respond to a significant demand for municipal borrowing.

At a minimum, consideration should be given to drawing on international donor support for the training and capacity building to key institutional participants in the market. In particular, training to the commercial banking sector in underwriting and managing municipal credits may contribute to advancing overall market development. Training and technical assistance directed at commercial lenders can help them to better understand the risks and rewards of municipal credits, and develop confidence in their ability to fund municipal investment as a profitable line of business activity. As this happens, they in turn will have the incentive and ability to educate prospective municipal borrowers on how to prepare municipal credits that satisfy sound underwriting requirements.



Looking beyond technical assistance, the larger policy development process framework should assess the pros and cons (as highlighted in Chapter II, above) of creating a specialized municipal credit intermediary as a transitional institution to facilitate the entry of private financial sector institutions into municipal lending for investment purposes.

In conclusion, as underscored at the outset of this report, Bulgaria has a unique and timely opportunity to establish a well-conceived policy and legal framework in advance of the market's development—rather than having to return and implement remedial measures on a retroactive basis.

ANNEX A

LIST OF LAWS AND REGULATIONS REVIEWED BY PROJECT TEAM

Key to Abbreviations:

NA = National Assembly

PD = Presidential Decree

CM = Council of Ministers

No.	Laws, Decrees, Regulations, Standards, etc.	Passed	Promulgated in Official Gazette	Amendments & Supplements
<i>Laws Relating to Fiscal Decentralization and Municipal Finance</i>				
1	Local Self-Government and Local Administration Act	NA 6-IX-91	No. 77,17-IX-91	No. 24,14-III-95, No. 49,30-V-95, No. 65, 21-VII-95, No. 30, 24-X-96, No. 122, 19-XII-97, No. 33, 24-III-98, No. 133,05-XI-98, No. 154,28-XII-98, No. 67,27-VII-99, No. 69,03-VIII-99
2	Municipal Budgets Act	NA 11-III-98	No. 33, 24-III-98, By PD 95, 23-III-98	
3	National Budget Procedures Act	NA 25-VII-96	No. 67, 6-VIII-96, by PD 270, 25-VII-97	No. 46,10-VI-97
4	State Budget for the Republic of Bulgaria for 1998 Act		No. 123, 22-XII-97	
5	State Budget for the Republic of Bulgaria for 1999 Act		No. 155,29-XII-98	
6	State Financial Control Act		No. 12/09.02.1996	No. 155, 1998
7	The National Audit Office Act		71/11.08.1995	No. 16, 1996; No. 83, 1999
8	Currency Act		No. 83/21.09.1999	
9	Tax Administration Act	NA	No. 59, 9-VII-93	No. 19, 1996; No. 21, 1998 No. 153, 1998; No. 155,1998
10	Tax Procedures Act	NA 1-VII-93	No. 61, 16-VII-93	No. 20, 1996; No. 51, 1997; No. 115, 1997; No. 117, 1997; No. 59,1998; No. 153,1998; No. 57,1999
11	Government Collections Act (State receivables)	NA	No. 26, 26-III-96	No. 104, 1996; No. 51, 1997; No. 59, 1998

No.	Laws, Decrees, Regulations, Standards, etc.	Passed	Promulgated in Official Gazette	Amendments & Supplements
12	Accountancy Act	NA	No. 4, 15-I-91	No. 26, 1992; No. 55, 1993; No. 21, 1996; No. 33, 1996; No. 59, 1996; No. 52, 1997 No. 21, 1998; No. 57, 1999; No. 81, 1999; No. 83, 1999
13	National Accounting Standard 16: Presentation of Financial Statements of Public Financed Organizations	CM 31-III-98	No. 36, 1998	
14	Items of Income Under the Uniform Budget Classification	18-XII-1998		
15	Territorial, Urban, and Rural Development Act		No. 29,/10.04.1973	No. 32, 1973 No. 87, 1974; No. 102, 1977; No. 36, 1979 No. 2, 1980; No. 45, 1984; No. 19, 1985; No. 36, 1986; No. 14, 1988; No. 31, 1990; No. 32, 1990; No. 15, 1991; No. 63, 1995; No. 104, 1996; No. 41, 1998; No. 79, 1998 No. 124, 1998; No. 133, 1998; No. 26, 1999; No. 86, 1999
16	Regional Development Act		No. 26, 1999	
17	Law on Local Taxes and Fees	NA 27-XI-97	No. 117, 10-XII-97	No. 71, 1998; No. 83, 1998 No. 105, 1998; No. 153, 1998
18	State Property Act	NA 8-V-96	No. 44, 21-V-96	Nos. 104/1996; 55, 61 & 117/1997; 93 & 124/1998; 67/1999
19	Ownership Act		No. 92/16.11.1951	Nos. 12/1958; 90/1960; 99/1963; 26 & 27/1973; 54 & 87/1974; 55/1978; 36/1979; 19/1985; 14 & 91/1988; 38/1989; 31/1990; 77/1991; 33/1996; 100/1997
20	Municipal Property Act	NA 9-V-96	No. 44, 21-V-96	Nos. 104/1996, 55/1997, 22& 93/1998; 23, 56, 64 & 67/1999
21	Regulations for Application of the Municipal Property Act	CM 235, 19-IX-96	No. 82, 27-IX-96	CM 104/97, in No. 24, 21-III-97; CM 304/07, In No. 62, 5-VIII-97
22	Concessions Act	NA 5-X-95	No. 92, 17-X-95	No. 16, 1996 No. 44, 1996 No. 61, 1997 No. 123, 1997 No. 93, 1998 No. 23, 1999

No.	Laws, Decrees, Regulations, Standards, etc.	Passed	Promulgated in Official Gazette	Amendments & Supplements
				No. 56, 1999 No. 64, 1999 No. 67, 1999
23	On Adoption of Rules Governing the Application of the Concessions Act	CM 240, 13-XII-95	No. 111, 22-XII-95	No. 15, 1997 No. 39, 1998

Laws Relating to Privatization

24	On the Transfer of Real Rights on Immovable Property when Establishing, Transforming, and Privatizing State Enterprises		No. 93/02.11.1993	
25	on the Enforcement of the Financial Recovery of State-owned Enterprises Act	DECREE No. 213 of 22 August 1996	No. 72/23.08.1996	Nos. 109/1996; 85/1998
26	on the Adoption of Regulations on the Terms and Procedures for Using Resources from the Recovery Fund under the State-owned Enterprises Financial Recovery Act	DECREE No. 303 of 19 December 1996	No. 109/1996	
27	On the Appraisal of the Property of State and Municipally-Owned Enterprises in their establishment as, and Transformation into Sole-Owner Companies with State Property		No. 78/20.09.1991	
28	Financial Recovery of State Owned Enterprise Act		No. 68/09.08.1996	
29	Transformation and Privatization of State-Owned and Municipal Enterprises (Privatization Act)		No. 38, 1992	No. 51, 1994; No. 45, 1995; No. 57, 1995 No. 109, 1995; No. 42, 1996; No. 45, 1996 No. 68, 1996; No. 85, 1996; No. 55, 1997 No. 61, 1997; No. 89, 1997; No. 98, 1997; No. 122, 1997; No. 39, 1998; No. 41, 1998 No. 70, 1998; No. 12, 1999; No. 47, 1999; No. 56, 1999; No. 84, 1999;

Water, Energy, and Environmental Laws

No.	Laws, Decrees, Regulations, Standards, etc.	Passed	Promulgated in Official Gazette	Amendments & Supplements
30	Water Law		No 76, 7/07/1999	
31	Regulation No. 9 of 14th of September, 1994 on the Use of Water Supply and Sewerage Systems		No.77 of 23rd Sep, 1994	No.7 of 23rd Jan. 1996, No.3 of 10th Jan., 1997, No.16 of 10th Feb., 1998, No.47 of 24th Apr, 1998, No.3 of 12th Jan. 1999, No.70 of 6th Aug., 1999.
32	Environment Protection Act		No. 86/18.10.1991	No. 100, 1992; No. 31, 1995; No. 63, 1995 No. 13, 1997; No. 85, 1997; No. 86, 1997 No. 62, 1998; No. 12, 1999; No. 67, 1999
33	Energy and Energy Efficiency Act		No. 64, 1999	
34	Regulation No. 4 on Environmental Impact Assessment		No. 84/22.07.1998	

Capital Market Laws

35	Banking Act	NA	No. 52, 1-VII-97	No. 15, 1998; No. 21, 1998; No. 52, 1998 No. 70, 1998; No. 89, 1998; No. 54, 1999
36	Bulgarian National Bank Act		No. 46, 10-VI-97	No. 49, 1998; No. 153, 1998; No. 20, 1999 No. 54, 1999
37	Regulation No. 8, On the Capital Adequacy of Banks	July 15, 1997	No. 62/05.08.1997	
38	Regulation No. 9, On the Evaluation of Risk Exposures of Banks and the Allocation of Provisions to cover the Risk Related Thereto	July 15, 1997	No.77 of 23rd Sep, 1994	No.7, 1996, No.3, 1997, No.16, 1998, No.47 1998, No.3 1999, No.70, 1999.
39	State Bank for Investment and Development Act		No. 95/07.11.1996	No. 52, 1997; No. 153, 1998
40	Securities, Stock-Exchanges, and Investment Companies Act	NA	No. 63, 14-VII-95	No. 68, 1996; No. 85, 1996; No. 52, 1997; No. 94, 1997; No. 42, 1998; No. 52, 1998 No. 127,1998; No. 29,1999
41	On Adoption of an Ordinance on Prospectuses for Public Offering of Securities (Decree No. 49)	March 14, 1996	23/16.03.1996	
42	For the Implementation of the National Audit Office Act		28/02.04.1996	
43	Supplementary Voluntary Pensions Insurance Act	NA 7-VII-99	No. 65, 1999	
44	Foreign Investment Act		No. 97/24.10.1997	Nos. 99/1997, 29 & 153/1998

No.	Laws, Decrees, Regulations, Standards, etc.	Passed	Promulgated in Official Gazette	Amendments & Supplements
45	For adopting a Regulation on the Capital Adequacy and liquidity of investment brokers		Decree No. 370 of 9 October 1997	
46	On the Adoption of a Regulation on the Requirements to the activity of Investment Intermediaries		No. 95/21.10.1997	
47	Registered Pledges Act		No. 100/22.11.1996	No. 86, 1997; No. 42, 1999

Other Laws

48	Constitution of the Republic of Bulgaria		No. 56,1991	
49	Code of Civil Procedure		12/08.02.1952	Nos.92/1952;89/1953;90/1955;90/1956; 90/1958;50,90&99/1961;AmendedStateGazette Nos. 1/1963; 23/1968; 27/1973; 89/1976; 36/1979; 28/1983; 41/1985; 27/1986; 55/1987; 60/1988; 31 & 38/1989; 31/1990; 62/1991; 55/1992; 61 & 93/1993;87/1995; 12, 26, 37,44 & 104/1996; 43, 55 & 124/1997; 21, 59, 70 & 73/198; 64/1999
50	Obligations and Contracts Act		No. 275/22/11/1950	No. 2, 1950; No. 69, 1951; No. 92, 1952; No. 85, 1963; No. 27, 1973; No. 16, 1977 No. 28, 1982; No. 30, 1990; No. 12, 1993; No. 56, 1993; No. 83, 1996; No. 104, 1996 No. 83, 1999
51	Penal Code		No. 26/02.04.1968	Nos. 29/1968; 92/1969; 26 & 27/1973; 89/1974; 95/1975; 3/1977; 53/1978; 89/1979; 28 & 31/1982; 44/1984; 41, 79 & 80/1985; 89 & 90/1986; 37, 91 & 99/1989; 10, 31 & 81/1990; 1, 86, 90 & 105/1991; 54/1992; 10/1993; Decision No. 19/1995 of the Constitutional Court; SG Nos. 50 & 102/1995; 107/1996; 62 & 85/1997; 83, 85, 132, 133 & 153/1998; 7 & 51/1999
52	Administrative Violations and Sanctions Act		No. 92/28.11.1969	Nos. 54/1978; 28/1982; 28 & 101/1983; 89/1986; 24/1987; 94/1990; 105/1991; 59/1992; 102/1995; 12 & 110/1996; 11/1998, 15, 59 & 85/1998; 5 & 671/1999
53	Formation of state Property and Sole		No. 55/12.07.1991	No. 38/1992, 30/1999

No.	Laws, Decrees, Regulations, Standards, etc.	Passed	Promulgated in Official Gazette	Amendments & Supplements
	Proprietor Companies Act			
54	Cooperatives Act		63/03.08.1991	Nos. 34 & 55/1992; 63/1994; 59 & 103/1996; 52/1997; 52/1998; 81/1999
55	Corporate Income Tax Act		No. 115/05.12.1997	Nos. 21 & 153/1998; 12, 50, 51, 64 & 81/1999
56	Value added tax act		No. 153/23.12.1998	No. 01/1999, 62 & 64/1999
57	Taxation of the income of natural persons act		No. 118/10.12.1997	No. 35, 71 & 153/1998; 50/1999
58	Insurance Act		No. 86/11.10.1996;	1,21&58/1997, 21,52,93&132/1998; 88/1999
59	Protection of Competition Act		No. 52/08.05.1998	No. 112/1998, 81/1999
60	Commerce Act		No. 48/18.06.1991	Nos. 25/1992; 61 & 103/1993; 63/1994; 63/1995; 42, 59, 83, 86 & 104/1996; 58, 100 & 124/1997; 39, 52 & 70/1998; 33, 42, 64 & 81/1999
61	Public Procurement Law		No. 56,1999	

ANNEX B

LIST OF PERSONS INTERVIEWED FOR THE BULGARIAN MUNICIPAL CREDIT AND FINANCE REFORM STUDY (NOTE: Interviews conducted during October through December, 1999)

I. National Government

Vassilena Ananyeva	Chief of Department of Local Government	Ministry of Finance
Krassimir Angarski	Economic Secretary	President of the Republic of Bulgaria
Elena Avramova	Head of Budget-Funded Organs Accounting, Accounting Methodologies	Ministry of Finance
Gergana Beremska	Head of Analyses and Forecasts, Government Debt Department	Ministry of Finance
Mrs. Chavdarova	Head of Regional Development	Ministry of Regional Development and Public Works
Ms. Chermalova	Head of National Development Planning	Ministry of Regional Development and Public Works
Ivanka Daneva	Head of Registration and Supervision of Issues	Securities and Stock Exchange Commission
Toma Jekov	Head of State Auditing	Ministry of Finance
Nona Karadjova	Head of Strategy and European Integration	Ministry of Environment and Waters
Daniela Konova	Director	Insurance Supervision Directorate
Gueorgui Nikolov	President	National Audit Office
Rossitza Nikolova	Head of Strategy and Policy for Integrated Water Management	Ministry of Environment and Water
Zlatka Ormanova	Head of Local Government	Ministry of Regional Development and Public Works
Yuri Petroff	Head of Finance	World Bank Water Loan Project Management Unit
Borislav Petrov	Director	World Bank Water Loan Project Management Unit
Tsvetan Petrov	Head of Section, Local Government Department	Ministry of Finance
Zoya Petrova	Chief of Accounting Methodology	Ministry of Finance
Tinka Popova	Director of Targeted Investment Grants	Ministry of Finance
Ivan Saev	Head of Public Works	Ministry of Regional Development and Public Works
Mariana Touhtchieva	Head of International Department	Ministry of Finance
Radoslav Tzonchev	Chairman	Council of Ministries, Bulgarian Securities Commission

II. Municipal Sector

Anton Anonov	Head of Waste	City of Rousse
Krassimir Arssow	Executive Director	TSCHISTOTA-Sofia
Tetya Atsinova	Director	Stara Zagora Regional Economic Development Agency
Georgy Auramov	Deputy Mayor	Velingrad Municipality
Bonka Boicheva	Chief Accountant	City of Rousse

Georgi Belovski	Head of International Division	Sofia Municipal Bank
Mr. Dimov	Deputy Head of Velingrad Tax Administration	Ministry of Finance (Velingrad office)
Slavka Dragneva	Finance Director	Stara Zagora Municipality
Bogdan Ganev	Chief	Rousse Transport Company
Andrei Gospodinov	Manager	Blagoustroivane
Dmitri Kalthev	Mayor	City of Rousse
Ginka Kapitanova	Director	Foundation for Local Government Reform
Ventzeslav Nikolov	Deputy Mayor	Sofia Municipality
Mrs. Petkova	Chief Accountant	Sofia Municipal Transport Company
Zdravko Setchkov	Financial Manager	Foundation for Local Government Reform
Ms. Stancheva	Head of Finance	Sofia Municipal Transport Company
Alexander Stoimenov	Manager	Gabrovo Municipal Transport Company
Ginka Tchavdarova	Executive Director	National Association of Municipalities
Vassil Vassilev	Executive Director	Sofia Municipal Bank
Tsanko Yablanski	Mayor	Stara Zagora Municipality
Kostadin Yanev	Chairman of Executive Committee	Sofia Energy Consortium

III. Capital Market

Nikola Abadjiev	General Manager	Association of Pension Funds Social Security Fund "Sila"
Vessela Akabalieva	Managing Director	Unity Invest – 99
Hristina Alexandrova	Head of Finance and Budgeting	Gabrovo Municipality
Mario Anastasov	Head of Capital Markets and Liquidity	DSK Bank
Michael Atanassov	Broker	Unity Invest – 99
Cheskaha Benkova	Head of Credit	DSK Bank
Georgi Belovski	Head of International Division	Municipal Bank PLC
Spas Dimitrov	President Executive Director	Bulgarian Bankers Association DSK Bank
Tchavdar Dragiev	Director of the Association Executive Director	Licensed Investment Intermediaries; Dealing Financial Company, Inc.
Krassimir Jadhidinev	Partner	KPMG Bulgaria
Raiko Karagyozov	Head of Liabilities Management and Branch Network Division	Municipal Bank PLC
Kamen Kolchev	Director Chief Executive Officer	Association of Financial Intermediaries Elana Inc.
Tsvetanka Ilieva	Procurator	Unity Invest – 99
Volma Marinova	Deputy Chairman	DSK Bank
Andrey Nikolov	Chairman and Head of Credit Management	United Bulgarian Bank
Jeni Parpulova	Secretary General	Association of Bulgarian Insurers

Radostina Radeva	Manager of Custody Department	Bulbank
Venelislav Rakovski	Vice President	Allianz
Vanya Vassileva	Deputy Chairman	Association of Commercial Banks
	Chief Executive Director	Municipal Bank PLC
Velko Velkov	Head of Investment Banking	United Bulgarian Bank
Martin Zaimov	Deputy Governor	Bulgarian National Bank

IV. International Donors, Staff and Contractors

Dontcho Barbalov	Senior Advisor, Capital Markets and Pension	USAID
Lewis Baurer	Tax Advisor	U. S. Department of the Treasury
Peter Borgo	Senior Engineer	Electrotek Concepts Inc.
Rosa Chiappe	Chief of Party	USAID Bulgaria Pension Project
Jim Corsiglia	Liaison	ABA/CEELI
Andrey Delchev	Managing Partner	Eurolex, Bulgaria LTD
Raina Dimitrova	Senior Advisor, Banking	USAID
Bill Foederer	Chief	USAID Private Enterprise Office
John Grant	Mission Director	USAID
Alan Hawkins	Resident Advisor for Bank Privatization	Barents
Balazs Horvath	Economist	International Monetary Fund
Christo Ivanov	Legal Advisor	ABA/CEELI
Albert Martinez	Principal Private Sector Development Specialist	World Bank
Jim McCullough	Public Finance Specialist	USAID-LGI (RTI)
Kaye Pyle	Local Government Specialist	USAID
Alan Rosenberg	Chief of Party	USAID Bulgaria Securities and Stock Exchange Project
Emil Savov	Municipal Finance Specialist	USAID-LGI (RTI)
Pedro Souss	Information Technology, Bulgarian Pension Project	USAID
Tom Spofford	Public Finance Specialist	USAID-LGI (RTI)
James Stewart, Jr.	Advisor to the Ministry of Finance and the Bulgarian National Bank	U. S. Department of the Treasury
Lada Stoyanova	Financial and Enterprise Sectors Specialist	World Bank
Scott Vicary	Financial Analyst/Project Manager	Electrotek Concepts Inc.

ANNEX C

WATER AND SEWERAGE ENTERPRISES IN BULGARIA BY TYPE OF OWNERSHIP

100 % MUNICIPAL

- 1. Sofia- 1**
- 2. Berkovitza**
- 3. Kneja**
- 4. Botevgrad**
- 5. Strelcha**
- 6. Teteven**
- 7. Panagjurishte**
- 8. Velingrad**
- 9. Batak**
- 10. Peshtera**
- 11. Sandanski**
- 12. Petrich**
- 13. Rakitovo**
- 14. Troyan**
- 15. Sevlievo**
- 16. Svishtov**
- 17. Kubrat**
- 18. Dupnitsa**
- 19. Belovo**
- 20. Bragigovo**

100 % STATE

- 1. Sofia-2**
- 2. Blagoevgrad**
- 3. Plovdiv**
- 4. Haskovo**
- 5. Burgas**
- 6. Razgrad**
- 7. Pazardjik**

MIXED (51 % STATE; 49 % MUNICIPAL)

- 1. Vidin**
- 2. Kjustendil**
- 3. Vratza**
- 4. Pleven**
- 5. Lovech**
- 6. Tzarevetz**
- 7. Sliven**
- 8. Targovishte**
- 9. Rousse**
- 10. Silistra**
- 11. Dobrich**
- 12. Varna**
- 13. Dimitrovgrad**
- 14. Shumen**
- 15. Gabrovo**
- 16. Stara Zagora**
- 17. Kardjali**
- 18. Smolyan**
- 19. Montana**
- 20. Yambol**
- 21. Isperih**
- 22. Pernik**

SOURCE: WORLD BANK PROJECT MANAGEMENT UNIT,
BULGARIA WATER COMPANIES RESTRUCTURING AND
MODERNIZATION PROJECT (November 1999)

ANNEX D MUNICIPAL BUDGET DATA

TOTAL ALL MUNICIPALITIES AND TOWNS				
<i>million current old leva</i>	1996 Actual	1997 actual	1998 actual	1999 budget
1 Local taxes	5,973	20,338	82,992	97,349
2 Local fees	5,409	31,754	104,162	126,935
3 Other current local revenues	6,483	30,441	49,468	107,761
4 Total shared revenues	53,946	557,087	775,310	911,296
5 Current net transfers	33,303	305,794	487,846	435,908
6 TOTAL CURRENT REVENUES	105,114	945,414	1,499,778	1,679,249
7 Wages and social security	46,179	459,840	712,582	845,684
8 Materials and services (incl.travels)	46,617	358,056	571,364	652,248
9 Current transfers and subsidies	7,921	91,111	161,347	146,746
10 Interest payments	208	362	1,201	2,355
11 Other current expenditures	1	1,546	1,147	649
12 TOTAL CURRENT EXPENDITURES	100,926	910,914	1,447,640	1,647,683
13 Gross operating savings (6-12)	4,188	34,500	52,138	31,566
14 % of current revenues (13/6)	4.0%	3.6%	3.5%	1.9%
15 Loan repayment	839	307	1,428	0
16 Net operating savings (13-15)	3,348	34,193	50,710	31,566
17 % of current revenues (16/6)	3.2%	3.6%	3.4%	1.9%
18 TOTAL CAPITAL EXPENDITURES	9,066	79,348	212,050	211,588
19 TOTAL CAPITAL INCOME	4,199	54,020	141,810	117,449
20 percent of expend. Funded (19/18)	46.3%	68.1%	66.9%	55.5%
21 Balance after investment (16+19-18)	(1,519)	8,865	(19,530)	(62,574)
22 Borrowing / Financing of Balance	2,150	3,267	22,017	106,273
23 Financial transaction	22	5	0	(60,000)
24 Expenditures / revenues balance (21+22+23)	652	12,137	2,487	(16,301)
25 Deposits in bank accounts	0	625	13,880	16,301
26 Total unpaid expenditures	(11,584)	(23,809)	(74,442)	0
27 End of year Budget Balance (24+25+26)	(10,932)	(11,047)	(58,075)	0
28 as percent of total revenue	-9.8%	-1.1%	-3.5%	0.0%
29 Target subsidies for environmental projects	472	1,850	6,263	11,373
30 Off-budget - balance	4,807	36,660	46,719	0
31 End of year balance (27+29+30)	(5,654)	27,463	(5,093)	11,373

**MUNICIPALITIES < 10,000
INHABITANTS**

<i>million current old leva</i>	1996 actual	1997 actual	1998 actual	1999 budget
1 Local taxes	223	725	3,005	3,089
2 Local fees	268	2,171	5,380	5,689
3 Other current local revenues	440	2,316	2,705	5,122
4 Total shared revenues	2,728	35,918	35,802	42,025
5 Current net transfers	3,333	30,070	51,540	51,717
6 TOTAL CURRENT REVENUES	6,991	71,200	98,432	107,643
7 Wages and social security	3,002	32,787	52,003	63,335
8 Materials and services (incl.travels)	2,809	23,628	33,239	32,163
9 Current transfers and subsidies	282	5,828	11,360	14,598
10 Interest payments	0	0	0	0
11 Other current expenditures	1	5	20	8
12 TOTAL CURRENT EXPENDITURES	6,094	62,249	96,622	110,104
13 Gross operating savings (6-12)	897	8,951	1,810	(2,461)
14 % of current revenues (13/6)	12.8%	12.6%	1.8%	-2.3%
15 Loan repayment	34	0	0	0
16 Net operating savings (13-15)	863	8,951	1,810	(2,461)
17 % of current revenues (16/6)	12.3%	12.6%	1.8%	-2.3%
18 TOTAL CAPITAL EXPENDITURES	1,176	11,863	11,444	12,585
19 TOTAL CAPITAL INCOME	296	4,594	9,120	12,343
20 Percent of expend. Funded (19/18)	25.1%	38.7%	79.7%	98.1%
21 Balance after investment (16+19-18)	(17)	1,683	(514)	(2,703)
22 Borrowing / Financing of Balance	124	(1)	29	1,502
23 Financial transaction	4	0	0	0
24 Expenditures / revenues balance (21+22+23)	111	1,681	(485)	(1,201)
25 Deposits in bank accounts	0	122	1,953	1,201
26 Total unpaid expenditures	(830)	(733)	(4,303)	0
27 End of year Budget Balance (24+25+26)	(719)	1,070	(2,836)	0
28 as percent of total revenue	-9.7%	1.4%	-2.6%	0.0%
29 Target subsidies for environmental projects	7	12	100	125
30 Off-budget - balance	224	1,519	1,766	0
31 End of year balance (27+29+30)	(488)	2,601	(970)	125

MUNICIPALITIES 10-20,000 INHABITANTS

<i>million current old leva</i>	1996 actual	1997 actual	1998 actual	1999 budget
1 Local taxes	510	1,296	5,422	5,492
2 Local fees	491	3,099	10,465	11,577
3 Other current local revenues	722	3,524	5,073	6,082
4 Total shared revenues	4,533	52,988	69,684	75,242
5 Current net transfers	6,342	55,068	84,006	82,652
6 TOTAL CURRENT REVENUES	12,598	115,976	174,650	181,046
7 Wages and social security	5,946	59,597	91,476	108,399
8 Materials and services (incl.travels)	5,381	39,906	57,900	50,998
9 Current transfers and subsidies	785	11,349	21,266	26,268
10 Interest payments	0	0	0	15
11 Other current expenditures	0	156	53	28
12 TOTAL CURRENT EXPENDITURES	12,112	111,007	170,695	185,709
13 Gross operating savings (6- 12)	485	4,969	3,956	(4,663)
14 % of current revenues (13/6)	3.9%	4.3%	2.3%	-2.6%
15 Loan repayment	86	0	0	0
16 Net operating savings (13- 15)	399	4,969	3,956	(4,663)
17 % of current revenues (16/6)	3.2%	4.3%	2.3%	-2.6%
18 TOTAL CAPITAL EXPENDITURES	882	8,724	16,473	16,135
19 TOTAL CAPITAL INCOME	401	6,330	12,385	15,541
20 percent of expend. Funded (19/18)	45.5%	72.6%	75.2%	96.3%
21 Balance after investment (16+19-18)	(81)	2,576	(133)	(5,257)
22 Borrowing / Financing of Balance	238	(257)	243	2,537
23 Financial transaction	3	0	0	0
24 Expenditures / revenues balance (21+22+23)	161	2,319	110	(2,720)
25 Deposits in bank accounts	0	161	2,596	2,720

MUNICIPALITIES 10-20,000 INHABITANTS

26	Total unpaid expenditures	(1,538)	(1,277)	(7,052)	0
27	End of year Budget Balance (24+25+26)	(1,377)	1,203	(4,346)	0
28	as percent of total revenue	-10.4%	1.0%	-2.3%	0.0%
29	Target subsidies for environmental projects	43	36	200	620
30	Off-budget - balance	435	3,299	4,275	0
31	End of year balance (27+29+30)	(900)	4,538	129	620

MUNICIPALITIES 20-50,000 INHABITANTS

	1996 actual	1997 actual	1998 actual	1999 budget
<i>million current old leva</i>				
1 Local taxes	954	2,505	11,149	10,690
2 Local fees	844	5,141	16,662	17,982
3 Other current local revenues	1,022	5,787	9,238	10,589
4 Total shared revenues	7,450	94,395	129,813	139,394
5 Current net transfers	9,794	80,062	116,764	106,380
6 TOTAL CURRENT REVENUES	20,063	187,890	283,626	285,035
7 Wages and social security	9,720	95,879	150,111	175,310
8 Materials and services (incl.travels)	8,611	64,760	96,232	76,881
9 Current transfers and subsidies	1,179	15,591	30,614	35,642
10 Interest payments	3	0	3	12
11 Other current expenditures	0	928	6	(6)
12 TOTAL CURRENT EXPENDITURES	19,513	177,158	276,966	287,840
13 Gross operating savings (6-12)	550	10,732	6,660	(2,805)
14 % of current revenues (13/6)	2.7%	5.7%	2.3%	-1.0%
15 Loan repayment	185	6	25	0
16 Net operating savings (13-15)	366	10,726	6,635	(2,805)
17 % of current revenues (16/6)	1.8%	5.7%	2.3%	-1.0%
18 TOTAL CAPITAL EXPENDITURES	1,050	15,191	25,679	20,721
19 TOTAL CAPITAL INCOME	471	6,161	17,303	18,453
20 percent of expend. Funded (19/18)	44.9%	40.6%	67.4%	89.1%
21 Balance after investment (16+19-18)	(213)	1,696	(1,741)	(5,073)
22 Borrowing / Financing of Balance	351	175	1,265	3,518
23 Financial transaction	7	0	0	0
24 Expenditures / revenues balance	144	1,871	(476)	(1,555)

MUNICIPALITIES 20-50,000 INHABITANTS
(21+22+23)

25	Deposits in bank accounts	0	115	2,178	1,555
26	Total unpaid expenditures	(2,262)	(2,316)	(12,363)	0
27	End of year Budget Balance (24+25+26)	(2,118)	(330)	(10,661)	0
28	as percent of total revenue	-10.1%	-0.2%	-3.5%	0.0%
29	Target subsidies for environmental projects	69	400	1,715	2,530
30	Off-budget - balance	630	4,468	6,596	0
31	End of year balance (27+29+30)	(1,419)	4,538	(2,350)	2,530

MUNICIPALITIES 50-100,000 INHABITANTS

<i>million current old leva</i>	1996 actual	1997 actual	1998 actual	1999 budget
Local taxes	1,080	2,725	11,387	13,107
Local fees	882	5,659	17,622	20,962
Other current local revenues	1,169	5,082	8,861	18,419
Total shared revenues	10,255	96,239	118,906	129,679
Current net transfers	6,805	61,147	95,946	91,839
TOTAL CURRENT REVENUES	20,191	170,852	252,722	274,006
Wages and social security	9,607	93,682	140,777	167,910
Materials and services (incl.travels)	8,959	63,336	90,606	88,640
Current transfers and subsidies	817	11,452	21,271	25,501
Interest payments	0	0	35	65
Other current expenditures	0	23	60	604
TOTAL CURRENT EXPENDITURES	19,383	168,493	252,749	282,721
Gross operating savings (6-12)	808	2,359	(28)	(8,715)
% of current revenues (13/6)	4.0%	1.4%	0.0%	-3.2%
Loan repayment	211	0	495	0
Net operating savings (13-15)	597	2,359	(523)	(8,715)
% of current revenues (16/6)	3.0%	1.4%	-0.2%	-3.2%
TOTAL CAPITAL EXPENDITURES	1,097	7,013	13,129	13,033
TOTAL CAPITAL INCOME	259	5,832	8,857	12,154
percent of expend. Funded (19/18)	23.7%	83.2%	67.5%	93.3%
Balance after investment (16+19-18)	(241)	1,177	(4,794)	(9,595)
Borrowing / Financing of Balance	359	217	5,206	7,792
Financial transaction	2	0	0	0

MUNICIPALITIES 50-100,000 INHABITANTS

Expenditures / revenues balance (21+22+23)	120	1,395	411	(1,802)
Deposits in bank accounts	0	116	1,521	1,802
Total unpaid expenditures	(2,326)	(4,486)	(12,700)	0
End of year Budget Balance (24+25+26) as percent of total revenue	(2,206) -10.6%	(2,975) -1.7%	(10,767) -4.0%	0 0.0%
Target subsidies for environmental projects	45	177	631	525
Off-budget - balance	841	6,623	9,826	0
End of year balance (27+29+30)	(1,320)	3,825	(311)	525

**MUNICIPALITIES >100,000
INHABITANTS**

<i>million current old leva</i>	1996 actual	1997 actual	1998 actual	1999 budget
1 Local taxes	1,765	6,955	26,807	32,270
2 Local fees	1,725	9,769	32,817	41,688
3 Other current local revenues	2,154	8,795	14,592	46,998
4 Total shared revenues	16,016	155,023	221,490	268,070
5 Current net transfers	6,559	62,853	106,751	79,264
6 TOTAL CURRENT REVENUES	28,219	243,395	402,457	468,291
7 Wages and social security	11,854	120,014	186,696	227,033
8 Materials and services (incl.travels)	14,411	104,956	169,755	186,145
9 Current transfers and subsidies	1,223	15,641	30,654	36,027
10 Interest payments	206	362	277	566
11 Other current expenditures	0	434	809	15
12 TOTAL CURRENT EXPENDITURES	27,693	241,406	388,191	449,786
13 Gross operating savings (6-12)	526	1,989	14,266	18,505
14 % of current revenues (13/6)	1.9%	0.8%	3.5%	4.0%
15 Loan repayment	307	301	908	0
16 Net operating savings (13-15)	219	1,688	13,359	18,505
17 % of current revenues (16/6)	0.8%	0.7%	3.3%	4.0%
18 TOTAL CAPITAL EXPENDITURES	1,394	12,794	63,544	41,281
19 TOTAL CAPITAL INCOME	451	9,618	42,241	20,658
20 percent of expend. Funded (19/18)	32.3%	75.2%	66.5%	50.0%

**MUNICIPALITIES >100,000
INHABITANTS**

21	Balance after investment (16+19-18)	(724)	(1,488)	(7,944)	(2,118)
22	Borrowing / Financing of Balance	734	1,087	10,160	(777)
23	Financial transaction	5	5	0	0
24	Expenditures / revenues balance (21+22+23)	15	(396)	2,216	(2,895)
25	Deposits in bank accounts	0	10	263	2,895
26	Total unpaid expenditures	(4,204)	(14,997)	(38,024)	0
27	End of year Budget Balance (24+25+26)	(4,189)	(15,383)	(35,544)	0
28	as percent of total revenue	-14.2%	-6.1%	-7.8%	0.0%
29	Target subsidies for environmental projects	125	825	1,455	3,573
30	Off-budget - balance	1,063	8,497	8,622	0
31	End of year balance (27+29+30)	(3,001)	(6,061)	(25,467)	3,573

SOFIA MUNICIPALITY

<i>million current old leva</i>	1996 actual	1997 actual	1998 actual	1999 budget
1 Local taxes	1,441	6,132	25,221	32,700
2 Local fees	1,200	5,917	21,216	29,037
3 Other current local revenues	976	4,937	8,998	20,551
4 Total shared revenues	12,964	122,523	199,615	256,885
5 Current net transfers	470	16,593	32,839	24,055
6 TOTAL CURRENT REVENUES	17,051	156,100	287,890	363,228
7 Wages and social security	6,048	57,880	91,517	103,696
8 Materials and services (incl travels)	6,447	61,471	123,632	217,421
9 Current transfers and subsidies	3,635	31,250	46,181	8,709
10 Interest payments	0	0	886	1,698
11 Other current expenditures	0	0	200	0
12 TOTAL CURRENT EXPENDITURES	16,130	150,601	262,417	331,523
13 Gross operating savings (6-12)	921	5,500	25,473	31,705
14 % of current revenues (13/6)	5.4%	3.5%	8.8%	8.7%
15 Loan repayment	16	0	0	0
16 Net operating savings (13-15)	905	5,500	25,473	31,705
17 % of current revenues (16/6)	5.3%	3.5%	8.8%	8.7%

SOFIA MUNICIPALITY

18	TOTAL CAPITAL EXPENDITURES	3,468	23,763	81,781	107,832
19	TOTAL CAPITAL INCOME	2,320	21,484	51,904	38,300
20	percent of expend. Funded (19/18)	66.9%	90.4%	63.5%	35.5%
21	Balance after investment (16+19-18)	(242)	3,221	(4,403)	(37,828)
22	Borrowing / Financing of Balance	343	2,046	5,115	91,700
23	Financial transaction	0	0	0	(60,000)
24	Expenditures / revenues balance (21+22+23)	101	5,267	712	(6,128)
25	Deposits in bank accounts	0	101	5,368	6,128
26	Total unpaid expenditures	(424)	0	0	0
27	End of year Budget Balance (24+25+26)	(323)	5,368	6,080	(0)
28	as percent of total revenue	-1.6%	3.0%	1.7%	0.0%
29	Target subsidies for environmental projects	184	400	2,162	4,000
30	Off-budget - balance	1,613	12,254	15,634	0
31	End of year balance (27+29+30)	1,474	18,022	23,876	4,000

ANNEX E

BACKGROUND REPORTS CONSULTED

Report Title	Author(s)
"Bulgaria: Municipal Finance Reform Strategy". The Urban Institute. December, 1997	Francis Conway, Hernando Garzon, Ritu Nayyar-Stone, Stefan Ivanov
"Local Finance". Club 'Ekonomika 2000'. March 1999	Stefan Ivanov
"Analysis of Municipal Financial Condition in 1998." RTI.	James S. McCullough
"Quantitative Analysis and Evaluation of Municipal Budgets in Bulgaria". 1998	Stefan Ivanov
IMF Documents (1998-1999): News Briefs, letters of intent, Memoranda of Economic Policies.	Government of Bulgaria
"Options for Changes in the Intergovernmental Transfers System." RTI.	James S. McCullough.
"Review of the Municipal Health Expenditures."	
"Definition of the existing distribution of responsibilities for service provision on various government levels" Draft 'A-Series' Report. Bulgaria LGI. 1999	Stanka Anguelova
"Review of Municipal Revenues" Draft 'A-Series' Report. Bulgaria LGI. 1999	Stefan Ivanov
"Municipal Expenditure Analysis". Draft 'A-Series' Report. Bulgaria LGI. 1999	Emil Savov
"Identify issues related to the existing condition". Draft 'A-Series' Report. Bulgaria LGI. 1999	Emil Savov
"To outline the possible changes in the responsibilities for provision of services". Draft 'A-Series' Report. Bulgaria LGI. 1999	James S. McCullough
"The Potential and Performance of the Local Property Tax." Plovdiv Fiscal Decentralization Project." Bulgaria: LGI. October 1993	Stefan Ivanov and James S. McCullough
"Establish Service Fees." Plovdiv Fiscal Decentralization Project. Bulgaria: LGI. July 1998	James Dohrman and Lina Ivanova
"Assess the Feasibility and Net Impact of Decentralizing the Administration of Local Taxes"	
"Using Third-Party Information to Improve the Administration of the Income (Patent) Tax on Small Businesses and Self-Employed in Bulgaria."	
"Lessons Learned. Final Report" . Plovdiv Fiscal Decentralization Project. Bulgaria: LGI. May 1999	James S. McCullough and Stefan Ivanov
"Delegation of Responsibility for Services and Supervision of Them". Policy Forum on Fiscal Decentralization in Bulgaria, 3-4 November 1998	Assen Diulgerov (Secretary of Sofia Municipality)
"Mechanism for Government Transfer Allocation to Municipalities". Policy Forum on Fiscal Decentralization in Bulgaria, 3-4 November 1998	Stefan Ivanov (Club E2K)
"Reforming Intergovernmental Transfer Systems: Lessons from Experience in Central and Eastern Europe". Policy Forum on Fiscal Decentralization in Bulgaria, 3-4 November 1998	Nick Devas (University of Birmingham)
"Local Revenue Structure". Policy Forum on Fiscal Decentralization in Bulgaria, 3-4 November 1998	Valentina Semerdjieva (Finance Director, Municipality of Plovdiv)
"Background Paper on Municipal Revenue Structure from the International Perspective". Policy Forum on Fiscal Decentralization in Bulgaria, 3-4 November 1998	James S. McCullough (RTI)
"Access to Funds for Capital Investment and Municipal Funding Technology". Policy Forum on Fiscal Decentralization in Bulgaria, 3-4 November 1998	Georgi Belovski (Sofia Municipal Bank)
"Background Paper on Local Government Debt: Policy Considerations from an International Perspective". Policy Forum on Fiscal Decentralization in Bulgaria, 3-4 November 1998	Matthew D. Glasser (RTI)
"A Set of Recommendations on the Practical Arrangements for the Issue of Municipal Bonds in Bulgaria". Working Paper. June 20, 1999.	Veneta Ilieva, Valentin Chavdarov, Svetlana Parpova...
The Political Economy of Fiscal Decentralization and Local Government Finance Reform in Poland	Tony Levitas
Bank Lending in Bulgaria: Problems, Explanations, and Policy Solutions	Kenneth Koford, Adrian Tschoegl (University of Delaware)

Report Title	Author(s)
Staff Appraisal Report Bulgaria: Water Companies Restructuring and Modernization Project	World Bank
DSK Bank, Annual Report	DSK Bank
List of Banks in Bulgaria	From Sofia.com website
World Bank documents: Project descriptions	World Bank
Country Assistance Strategy of the World Bank for Bulgaria	World Bank